OVERSIGHT OF THE FINANCIAL STABILITY OVERSIGHT COUNCIL

HEARING

BEFORE THE

SUBCOMMITTEE ON
OVERSIGHT AND INVESTIGATIONS

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

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WITNESSES

THURSDAY, APRIL 14, 2011

APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

OVERSIGHT OF THE FINANCIAL STABILITY OVERSIGHT COUNCIL

Thursday, April 14, 2011

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON OVERSIGHT
AND INVESTIGATIONS,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10:02 a.m., in room 2128, Rayburn House Office Building, Hon. Randy Neugebauer [chairman of the subcommittee] presiding.

Members present: Representatives Neugebauer, Fitzpatrick, Pearce, Posey, Hayworth, Renacci, Canseco; Capuano, Lynch, Waters, Miller of North Carolina, Ellison, Himes, and Carney.

Ex officio present: Representatives Bachus and Frank.

Also present: Representatives Biggert, Royce; Green, and Perlmutter.

Chairman NEUGEBAUER. This hearing will come to order. Without objection, all members' opening statements will be made a part of the record.

I will start by giving my opening statement.

Given the recent creation of and mandate of the Financial Stability Oversight Council (FSOC), it is important that we have this hearing today to better understand its roles and responsibilities, the impacts of its decisions on global competitiveness and our capital markets, and whether there is sufficient leadership by the Chairman of the Council to carry out the broad mandate called for in the Dodd-Frank Act.

I am deeply concerned that if the problems identified in this hearing today are not addressed early, this entity could have a severe negative impact on the functionality and the competitiveness of our businesses and our markets.

The Council states on its Web site that it is "committed to conducting its business in an open and transparent manner." Yet, documents reviewed by my staff clearly demonstrate that the Council has kept hidden from public view the criteria for formulating "systemically important" designations.

The Council also has a statutory duty to facilitate coordination among member agencies regarding policy development and rulemaking. Yet since the enactment of Dodd-Frank, there appear to be serious deficiencies in rulemaking coordination, most notably between the SEC and the CFTC.

The Council is also required to monitor international financial regulatory developments and "advise Congress and make rec-

ommendations in these areas that will enhance the competitiveness of U.S. financial markets." Yet, FSOC's initial recommendations under Dodd-Frank would place U.S. firms at a competitive disadvantage with its global counterparts.

Finally, the FSOC's role to designate certain non-bank financial firms as "systemically important" is proceeding without any representative at the Federal level who truly understands all of the businesses, for example, insurance.

I think one of the things that we are going to hear today is that this process is moving forward and decisions are being made without the voting member from the insurance agency being available or actually having been appointed.

We also have Mr. Huff here as well, whom I think will testify that he has been trying to get some additional help and resources because of this immense responsibility.

And because, I think, of the nature of FSOC, and it was thought by many to be one of the most important pieces of Dodd-Frank, this hearing today is extremely important, and I think there will be hearings in the future to monitor how these criteria are put together, how the FSOC as a committee is functioning, but that transparency piece is, I think, an extremely important piece of that because decisions are being made, evidently, within the organization. And when we look at the rules coming out, they are not matching up with some of the internal discussions. So the importance of this FSOC to, I think, the financial markets moving forward is an extremely important piece of our responsibility, and I look forward to hearing from our witnesses today.

And with that, I recognize the ranking member of the full committee, Mr. Frank. Thank you.

Mr. FRANK. Thank you, Mr. Chairman. The ranking member of the subcommittee is on his way over. We have a caucus.

One of the big issues that has been debated since the passage of the financial reform bill was whether the section dealing with systemically significant institutions was, in effect, a license for those so designated to take more risks because people would think they could never fail or whether it was something that would be more restrictive to them.

We believe very strongly that the law is very clear that being designated is more of a burden than a license, and we have had this debate. But it is now overwhelmingly clear what the answer is. It is seen more as a burden than as a license by the institutions involved.

What the FSOC has been getting is a series of lobbying efforts by institutions very eager not to be named, and that is a direct refutation of the argument that we created a too-big-to-fail element.

As a matter of fact, Adair Turner, who recently did a very good article, and I think we should be pursuing this question about what the real value is of much of the financial trading activity, but he notes in his very comprehensive study, "Public debate focuses on the need to avoid any taxpayer support in the future. Indeed, the Dodd-Frank bill in the U.S. makes it legally impossible to provide such support on a bank-specific basis."

So one of the things that is very clear, if there is a failure, then if the regulators think there needs to be something to alleviate the

consequences, it cannot be with taxpayer money. And so it is very clear that there is, I believe, clearly no such thing as too-big-to-fail.

Nothing can be done to deal with the consequences of such a problem until the institution is abolished. Again, somehow, in fact the institutions would like to be, they would benefit from being designated.

I would ask unanimous consent to put into the record these articles I am about to quote from.

From Tom Braithwaite in the Financial Times on April 3rd, "As Congress debated the law that became Dodd-Frank, lawmakers wrangled over the systemic risk designation. Some warned it would crystallize the too-big-to-fail funding advantage enjoyed by the largest groups by underlying the fact that government considered them crucial. Others said it would instead be a scarlet letter, a sign that profits would be hit by the new standards.

"Nine months after the designation became law, it looks like the scarlet letter brigade has won. Disclosures show a long list of companies and industry trade groups engaging in lobbying efforts. People involved in the talks say they are desperate to prove they do not deserve to be branded. They do not think that this is a great blessing and a license to be considered too-big-to-fail."

From Ian Katz, November 17th of last year, "BlackRock lobbies Fed to avoid designation as systemically important firm."

From that article on November 5th, "The Investment Company Institute, a Washington-based lobby group for the mutual fund industry, told the Council in a letter that mutual funds pose little threat to the U.S. financial system and should remain beyond the Fed's reach."

From Tom Braithwaite again in the Financial Times, "U.S. regulators divided on systematic risk list." He had two articles in the same paper, a busy day for him.

"Non-bank financial groups are engaged in their biggest lobbying effort since the passage of the financial reforms last year in an attempt to escape the net which they fear will hit profits with hundreds of millions of dollars of extra costs and trapped capital."

But then the other argument is, oh, well, this is going to put American banks at a disadvantage. So let me put into the record an article by Francesco Guerrera and Sharlene Goff in the Financial Times on April 11th, "Global banking regulation took a step towards convergence on Monday as a UK commission proposed measures that will bring the country's financial rules closer to the U.S."

In fact, there was a fear that Britain was going to be tougher than us. What we have is the financial institutions have had a very nice time. The British banks have said to the British people, "You are being too tough and we are going to America." The American banks said, "If you are so tough, we will go to England." I was afraid there was going to be a major clash in the Atlantic Ocean as they passed each other.

It is an illustration of a phenomenon I once discovered. It is my contribution to economic theory. I have been hearing for years about the absence of a level playing field, and it turns out it is a phenomenon of great interest.

There is apparently a constantly unlevel playing field in which no one has ever been at the top. You wouldn't think that was pos-

sible, but it is an unlevel playing field in which everybody is at the bottom.

Now, I think it is very clear from the behavior of the institutions that being designated is not a great boon. I don't think it will be a great negative either, because it will only lead to increased restrictions if people are behaving irresponsibly.

But, again, this argument as to whether or not the way this scheme was set forward in the bill enables institutions by certifying that they are too-big-to-fail or in fact potentially subject them to greater restrictions, capital increase, leverage requirements and others, it is overwhelmingly clear what the institutions themselves say.

For those who still say that this is somehow some great favor we have done the large institutions, I will quote again a quote from Marx that I have used before, and the Marx in question is Chico: "Who are you gonna believe, me or your own eyes?"

It is very clear from the evidence that what we tried to do last year is perceived by the institutions themselves as having worked the way we hoped it would.

I yield back.

Chairman NEUGEBAUER. I thank the ranking member of the full committee.

And now, I yield to the chairman of the full committee, Mr. Bachus, for 3 minutes.

Chairman BACHUS. Thank you, Mr. Chairman. And I thank the panelists for being here today.

The drafters of Dodd-Frank provided FSOC with new and far-reaching powers over the financial system, and the Council's use of the new powers will have a profound effect on our financial system and on our economy as a whole. And I think oversight of your activities is going to be a high priority for our committee.

One of the significant responsibilities, and Ranking Member Frank referred to this, is determining which non-bank financial institutions will be determined or would be designated as systemically important.

Of course, we know that all banks of over $50 billion, some 30-odd banks, will be automatically designated as such. And those 30 or so banks plus any non-financial institutions will have heightened prudential standards and Federal Reserve supervision. That, in and of itself, I don't think is a bad thing.

However, the moral hazard implications of these designations and of this power I think can't be overstated. The stamp of "systemically important" will be interpreted by many market participants as a designation of "too-big-to-fail," prompting them to exercise less market discipline when dealing with such firms.

Federal Reserve Governor Daniel Tarullo concedes that the designation could exacerbate moral hazard. In a speech on March 31st, he stated, "There is a reasonable concern that designating a small number of non-bank affiliated firms would increase moral hazard concern."

Additionally, I have questions regarding the transparency of the process for making the determination. Both the Council's advance notice for proposed rulemaking and its notice for proposed rulemaking restated language in the Dodd-Frank statute. However, re-

cent testimony from the FDIC Chairman and press reports indicate the Council is using additional standards to make its determination.

The significance of the systemic determination process requires transparency, and the Council should clarify what metrics are being used to classify firms in addition to those in the statutory language.

Congress must also ensure that the Council fulfills its statutory duty to coordinate the rulemaking, reporting, and enforcement actions of the financial regulators. I am sure, for instance that there has been a lot of discussion about the need for coordination at the CFTC and the SEC.

I think it is imperative for the Chairman of the FSOC, who is our Treasury Secretary, Secretary Geithner, to direct the Council's coordination efforts. And he should strive to ensure that the rules implementing Dodd-Frank are neither duplicative nor conflicting.

So far, the results on this front are not encouraging as regulators have not been successful at developing a coherent and coordinated approach on several fundamental issues with derivatives regulation and mortgage servicing standards. There appear to be conflicts and duplications.

I do believe that a lot of that is because of the short timeframe. It makes it almost impossible to have a coherent, organized rulemaking. And for that reason, I think that more time is needed than the statute gives. I would like to hear your comments on whether you have sufficient time.

Finally, decisions made by the Council must not undermine the competitiveness of U.S. financial firms or treat U.S. firms less favorably than their foreign competitors. The chairman of the subcommittee mentioned this.

The Council should be sensitive to how its rules and recommendations impact the ability of American companies to compete globally.

The Council should also keep in mind that in addition to being subject to Dodd-Frank, U.S. firms are also subject to Basel III capital standards, as well as rules issued by the Group of 20 and the Financial Stability Board. The activities undertaken by the Council show it may not be taking this issue as seriously as it needs to.

In response to a query on the international context of the Volcker Rule that was included in the Council's request for information for the Volcker study, I submitted a comment letter making the point that "unilateral U.S. adoption of the Volcker Rule could hurt the U.S. economy and create opportunities for regulatory arbitrage." This concern has been echoed by others.

However, the Council's final Volcker study indicated just one reference to concerns about U.S. global competitiveness. And the Council's study and recommendations on concentration limits for U.S. firms devoted less than a page to competitiveness concerns. I hope the panel will address these issues today.

I yield back the balance of my time.

Chairman NEUGEBAUER. I thank the chairman.

And now the ranking member of the subcommittee, Mr. Capuano?

Mr. CAPUANO. Thank you, Mr. Chairman.

First of all, I would like to thank you, ladies and gentlemen, for being here with us today, and I look forward to your testimony.

I want to make it clear that I am not interested in relitigating or re-debating the concepts that are here. The law was passed. I like most of it. I don't like some of it. But we are here. I am most interested in moving forward in what the FSOC is going to do going forward.

I will be clear. I believe that FSOC has a responsibility to clearly outline the criteria that you will be using for designating someone as a significantly important financial institution. I think it is only fair to the country, fair to the individual companies to let them know what rules will trigger what.

I also think that it is probably best to start with a relatively small list, because you have to start somewhere, and if you bite off more than you can chew, I think that is a recipe for disaster.

At the same time, I believe that the FSOC should be looking at a potentially significantly larger list of potential SIFI designees. Those are the people who would be just under the lines, whatever lines you draw, or people who might want to game the system.

And there will be someone who games the system. We all know that. As a matter of fact, the minute you come up with a designation, everyone will try to game the system.

For instance, on the list that I just got last night of the banks, bank holding companies that will be automatically designated, there are 36 banks that are currently on that list. At least two of them could probably move a few numbers around on their balance sheets and be de-designated the very next day.

I don't really mind where you draw the initial line, but I think it is absolutely essential that you have a big group of other people that you are kind of keeping an eye on, that might become, for several reasons.

Number one is that things could change. You could change your opinion. Number two is that they could become significant in a day or a week. And number three is that, again, people will be gaming that system.

I do think it is probably fair to keep that list private, but also to let those people know that they are on that list of potential SIFIs so that they know they are being carefully scrutinized.

I also believe that some of the concerns that have been raised about the lack of coordination in the regulations between various agencies is a fair point. It is not useful anywhere, ever, to duplicate or overlap regulation.

And I actually think that is one of the main reasons for the existence of the Financial Stability Oversight Council. I believe that is one of their main responsibilities, to get agencies to work together and to not overly burden the system.

I am not in favor of overregulation. However, I am also not in favor of under-regulation. Overregulation is clearly defined at least in one case where you have the same agencies requiring different things for the same activity. That makes no sense, unless there is a reason. If there is a reason, then both agencies should be requiring both activities.

And I guess, finally, I would like to make it clear that as far as I am concerned, the activities that you are engaged in and that will

be discussed today are a living thing. It is not just something that we wrote down in concrete never to be changed.

The regulations will be critically important. Whatever regulations you come up will probably have to be amended in the next year or two because you will miss something, or somebody will game something. You will realize something has to change.

I actually believe that the reason we had a financial crisis is because the regulators all stayed in their own little silos and didn't move beyond them when the entire financial services industry said, "That is the little silo you are in? Fine. We are moving outside."

I think if the regulators had been more flexible and more broad in their perspective, we would not have had the financial meltdown that we had.

But either way, I think that whatever you do, there will be mistakes. There will be things that I don't agree with, and there will be things that I agree with. But I hope that you all look at it as a living, breathing item to be amended as you go forward, particularly in the first couple of years.

As far as I am concerned, we are about to engage in things that we have never done, which I think makes it, number one, important, and number two, critically, that it be flexible. And with that, I will end simply, again, by saying thank you, and I look forward to your testimony.

Chairman NEUGEBAUER. And I thank the ranking member.

And now, the vice chairman of the subcommittee, Mr. Fitzpatrick for 1½ minutes.

Mr. FITZPATRICK. Thank you, Mr. Chairman.

We are here today to receive some clarity on the intentions of FSOC. And I know we all appreciate the panel and the witnesses being here to hopefully provide some of that.

Among FSOC's most important, and perhaps most impactful duties, is to determine which financial institutions may provide systemic risks to our economy.

Considering the financial crisis we just went through, we want to improve our regulatory system and have procedures in place to monitor the financial sector. I think it is important, however, that we not allow our zeal to put American companies at a disadvantage or, more importantly, to make us set aside some fundamental American principles.

Sound rules are necessary, and regulation allows us to enforce those rules. But we must be fair, and we have to adhere to established procedures.

American companies deserve a transparent, clear and open process, a designation process that includes safeguards to ensure that the right companies are receiving proper scrutiny, and detailed criteria to provide a clearly defined framework that all the affected parties understand and are able to work within.

I do not believe any member of this committee will object to fair and reasonable rules with a well-defined regulatory system to enforce them. We only seek to understand how these rules are being made and how America's financial regulators are going to ensure that American companies will continue to succeed and continue to be able to provide American jobs.

Thank you, Mr. Chairman.

Chairman NEUGEBAUER. Thank you.

And now, the gentlewoman from New York, Ms. Hayworth?

Dr. HAYWORTH. Thank you, Mr. Chairman.

And I am honored to be participating with all of you in this hearing because we are pursuing, as we must, a key oversight function. Dodd-Frank represented, in the minds of many of us, an enormous overreach and one that is, in fact, putting our economy and job growth in jeopardy.

The FSOC is a very important part of Dodd-Frank. It has the authority to measure systemic risk, to identify institutions that pose that risk. And, of course, FSOC also has to establish enhanced regulations for those institutions.

So we are asking you as regulators to act in agreement as a Council as you exercise this extraordinary level of authority. And I trust you to be executing that responsibility to the utmost of your ability. There is no question.

But I want to make sure that, indeed, FSOC is acting as intended, to identify systemic risk in a way that doesn't increase—and to define systemic risk in a way that doesn't increase moral hazard of too-big-to-fail, that doesn't create market distortion because of the perception that the Federal Government is going to guarantee certain aspects of market activity.

This, of course, was at the root of the 2008 crisis in the minds of many of us, and certainly including me. So today, in our oversight function, we seek your help in decreasing ambiguity, decreasing uncertainty, and decreasing unintended consequences which is a theme, as you know, among us this year, for so many reasons.

So I thank you in advance for your candid and thorough answers as we all work through the challenges that are posed to FSOC and also are posed by FSOC.

And with that, I yield back, Mr. Chairman.

Chairman NEUGEBAUER. And now to the gentlewoman from California, Ms. Waters?

Ms. WATERS. Thank you. Thank you, Mr. Chairman.

In 2008, the financial markets of the United States melted down and today, nearly 3 years later, our Nation is still struggling to get out of the economic quagmire that meltdown caused.

The meltdown, which was caused by the greed and irresponsibility of several banks on Wall Street but had systemic implications for the entire market, had real negative impacts on everyday Americans. These costs included the loss of over $10 trillion in household wealth and the loss of 10 million jobs. Since the meltdown, incomes have declined, with households losing an average of $3,250.

All of this is to say that Democrats realized that we had to act to protect our financial markets and to prevent institutions from becoming too-big-to-fail and the result of Democrats' action was the Dodd-Frank Wall Street Reform and Consumer Protection Act.

Dodd-Frank ends too-big-to-fail by providing a mechanism for the orderly liquidation of failing companies that guarantees the company dies while protecting the rest of the financial system.

Now, what did my friends on the opposite side of the aisle propose to help prevent another crisis? I heard the argument that the only way to end bailouts is to put firms through the bankruptcy

process. But that doesn't end too-big-to-fail, and it certainly won't prevent another crisis because bankruptcy itself can create systemic problems when used to unwind large, interconnected financial companies.

If my friends had their way, we would now have a system that would exacerbate, not solve those problems. In fact, I believe that if we had implemented a bankruptcy strategy as suggested by my friends on the opposite side of the aisle, the markets would have no confidence that another crisis would not occur and our hard-fought economic recovery would never have been achieved.

Therefore, Mr. Chairman, I strongly support the work Democrats undertook to save this Nation from another financial and economic collapse. The Dodd-Frank Act and the Financial Stability Oversight Council are critical to the continued stability of not just our financial markets, but also our economy.

I thank you, and I yield back the balance of my time.

Chairman NEUGEBAUER. I thank the gentlewoman.

And now the gentleman from Texas, Mr. Canseco, for 1 minute.

Mr. CANSECO. Thank you, Mr. Chairman.

And I would like to thank the witnesses for appearing here today and offering your testimony.

For the first time in history, Federal regulators have been asked to identify systemic risk in our financial markets. While it is a noble goal to root out systemic risk before it brings down a financial system, this new regulatory responsibility carries significant implications for our country and our economy.

The Financial Stability Oversight Council, FSOC, will have to make some of the most consequential decisions in the coming years about our financial institutions, financial markets, and our economy.

The Council needs to be certain that it does not legitimize the most damning accusations being made about its existence, that its function will be to identify firms that are too-big-to-fail and put taxpayers at risk yet again.

Recently, there have been some worrisome developments about the Council's operations. Proposed rules from the Council are extremely vague, and representatives from agencies that make up the Council have made conflicting statements about the Council's intent. I hope today's hearing serves to clarify what the Council's intentions are and what steps they are taking to protect our economy and our consumers.

Thank you very much, Mr. Chairman, and I look forward to hearing the testimony.

Chairman NEUGEBAUER. I thank the gentleman, and remind members that without objection, all members' statements will be made a part of the record.

I would now like to introduce our panel today: the Honorable Gary Gensler, Chairman of the Commodity Futures Trading Commission; the Honorable Jeffrey Goldstein, Under Secretary of Domestic Finance in the Department of the Treasury; the Honorable John Huff, Director of the Missouri Department of Insurance, Financial Institutions and Professional Registration; Ms. Nellie Liang, Director of the Office of Financial Stability Policy and Research, Federal Reserve; Robert Cook, Director of the Division of

Trading and Markets at the Securities and Exchange Commission; Mr. Arthur Murton, Director, Division of Insurance and Research, Federal Deposit Insurance Corporation; and Mr. Tim Long, Chief National Bank Examiner and Senior Deputy Comptroller for Regulatory Policy, Office of the Comptroller of the Currency.

I would remind all of you that without objection, all of your written statements will be made a part of the record. We ask you to limit your testimony to 5 minutes.

And with that, I recognize Chairman Gensler.

STATEMENT OF THE HONORABLE GARY GENSLER, CHAIRMAN, COMMODITY FUTURES TRADING COMMISSION (CFTC)

Mr. GENSLER. Good afternoon. Thank you, Chairman Neugebauer, Ranking Member Capuano, Ranking Member Frank, and all the members of the subcommittee. I thank you for inviting me here to speak at this hearing about FSOC. I am pleased to testify along with our fellow regulators here and to hear your thoughts.

I think that the FSOC provides an opportunity for regulators now and in the future to ensure that our financial system works better for all Americans. The financial system should be a place where investors and savers can get a return on their money. It should provide transparent and efficient markets where borrowers and people with good ideas and business plans can raise needed capital.

One of the challenges for the Council and for the American public is that, like so many other industries, the financial industry has gotten very concentrated around a small number of very large firms. And as it is unlikely that we could ever ensure that financial institutions will not fail, because surely some will fail in the future, we must do our utmost to ensure that when those challenges arise, the taxpayers are not forced to stand behind those institutions, and yes, that these institutions are free to fail.

There are important decisions that the Council will make, such as determinations about systemically important non-bank companies or SIFIs as you mentioned. There are other things about clearinghouses and completing studies and so forth.

More specifically, the Council is suggesting a clearinghouse. This is something that the CFTC gets very involved in, but some clearinghouses will be so large that they are systemically important. The CFTC has proposed comprehensive and robust rules to oversee the clearinghouses, including those that may be systemically important.

And I look forward to the Council's work moving forward. There will be some proposals on how that designation process should come forward. I think they should be detailed and the criteria should be explicit.

Further, the FSOC put forward a Volcker Rule study. This was very important for the CFTC because we, along with other Federal regulators, have to complete some proposals on the Volcker Rule.

It is our hope to put out a proposal sometime this summer along with other Federal regulators. And importantly, the study included derivatives as well as cash products to assure that there is not a regulatory arbitrage.

Though these specific issues are important, to me, it is essential the Council make sure that the American public doesn't bear the risk of the financial system and that the system works for the American public and investors and small business, retirees and homeowners.

To accomplish this, the regulators must coordinate closely on their mission and work together regularly to assess the health of the financial system and to make recommendations and annually report this to the Congress.

The CFTC is consulting heavily with the other agencies of the FSOC to implement all of this, but we are only one agency. And with regard to consultation, we put out all of our proposed rules, our term sheets, our memos to the seven other member agencies. We have been enormously benefited by the other agencies' direction and advice on this.

We are at a bit of a pause right now. We have about 45 rules outstanding. We have about four to go, maybe five. Before we move to any final rules, we are going to, again, get input from all of the seven member agencies. Most of that is from the Securities and Exchange Commission and the Federal Reserve because that is where most of the input is.

With that, I thank you, and I look forward to any of your questions.

[The prepared statement of Chairman Gensler can be found on page 60 of the appendix.]

Chairman NEUGEBAUER. Thank you, Mr. Gensler.

Mr Goldstein?

STATEMENT OF THE HONORABLE JEFFREY A. GOLDSTEIN, UNDER SECRETARY FOR DOMESTIC FINANCE, U.S. DEPARTMENT OF THE TREASURY

Mr. GOLDSTEIN. Mr. Chairman, Ranking Member Capuano, and members of the subcommittee, thank you for the opportunity to testify here today.

In July 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act created the Financial Stability Oversight Council to monitor and address risks to financial stability. In conjunction with my duties as Under Secretary of the Treasury, I serve as the Chair of the Council's Deputies Committee, as well as its Systemic Risk Committee. And I am working with my Council colleagues to build and execute the mandate of this new organization.

In the short time since the Dodd-Frank Act was signed into law, the Council has built its organizational framework, initiated monitoring for potential risks to financial stability, laid the groundwork for the designation of non-bank financial companies and financial market utilities, completed statutorily required studies, including a study on the effective implementation of the Volcker Rule, and served as a forum for discussion and coordination among the agencies implementing Dodd-Frank.

We have built the structure for the Council that is designed to promote accountability and action. The Council's work monitoring systemic risk has focused on significant market developments that could affect the financial system.

The remainder of the Council's agenda over the 8 months has been driven by specific statutory responsibilities. For example, in January the Council released studies on the Volcker Rule which prohibits proprietary trading by banking entities and on the Dodd-Frank Act's limits on concentration of large financial companies.

In addition, as Chair of the Council, the Treasury Secretary is required to coordinate several major rulemakings, including joint rulemakings on credit risk retention and the Volcker Rule.

We are also developing an analytic framework for, and have engaged in a public rulemaking related to, two of the Council's most important authorities, its authority to designate non-bank financial companies for consolidated supervision and financial market utilities for heightened standards.

Through its designation authority, the Council will help ensure that large interconnected financial companies whose material financial stress could pose a threat to U.S. financial stability will not be permitted to avoid adequate supervision based on their corporate form.

Similarly, the Council's work will help ensure that financial market utilities, which facilitate clearing settlements and payments, do not put the broader financial system at risk.

We expect to publish a final rule on the process and criteria for non-bank designations that will take into account the comments we have received and incorporate the qualitative and quantitative considerations mandated by the statute.

In that work, we are guided by a desire to ensure transparency and to obtain input from all interested parties. We are also committed to establishing a process that will endure changes in firms, markets and risks over time.

Our commitment to a robust designation process goes beyond transparency during rulemaking. Every designation decision will be firm-specific and subject to judicial review. Even before the Council votes on proposed designations, the company under consideration will have an opportunity to submit written materials to the Council concerning its designation.

If challenged, the designation will be subject to review through a formal hearing process and a two-thirds final vote, after which the Council must then provide to Congress a report detailing its final decision.

As we continue to work to implement the Wall Street reform legislation, our overarching goal will remain the same—to establish new rules of the road to fix what failed and contributed to the financial crisis. And the Council plays a critical role in achieving that goal.

Let me end by thanking the members for the opportunity to be here today, and I look forward to taking your questions.

[The prepared statement of Under Secretary Goldstein can be found on page 67 of the appendix.]

Chairman NEUGEBAUER. Thank you, Mr. Goldstein.

Mr. Huff?

STATEMENT OF THE HONORABLE JOHN M. HUFF, DIRECTOR, STATE OF MISSOURI DEPARTMENT OF INSURANCE, FINANCIAL INSTITUTIONS, AND PROFESSIONAL REGISTRATION, ON BEHALF OF THE NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS (NAIC)

Mr. HUFF. Thank you, Mr. Chairman, Ranking Member Capuano, and members of the subcommittee. Thank you for the opportunity to testify today.

My name is John Huff. I am Director of the Department of Insurance, Financial Institutions and Professional Registration for the State of Missouri. I serve as a non-voting member of FSOC.

I am also a member of the National Association of Insurance Commissioners, NAIC, and I am testifying on behalf of that organization today. Specifically, I am here to discuss the experiences of our Nation's 56 insurance regulators and working through NAIC with FSOC.

There are three matters I wish to address in my testimony today. First, insurance is a unique product, fundamentally different from banking and securities products. Second, in passing Dodd-Frank, we believe that Congress intended that insurance regulators have thorough representation on FSOC.

And finally, despite the NAIC's best efforts, there is inadequate insurance expertise on FSOC today, a problem that will continue for the foreseeable future.

Insurance is a unique product, and insurance policies involve upfront payments in exchange for a legal promise is to pay benefits in the event of a future loss. Contrasting bank products involving money deposited by customers subject to withdrawal on demand at any time, insurance products are not.

U.S. insurance companies are also subject to stringent capital requirements, limits on the nature and extent of their investments, and quarterly analysis and periodic examination. These regulatory reviews enabled the insurance sector to weather the recent financial crisis better than other sectors.

For these reasons, it is the view of the NAIC that traditional insurance products and activities do not typically create systemic risk. However, connections with other financial activities and noninsurance affiliates may indeed expose some insurers to the impact of systemic risk, and certain products may provide a conduit for systemic risk.

Beyond our participation on FSOC, the NAIC is taking steps to mitigate systemic risk and address the areas of concern that were raised during the recent financial crisis.

Through the NAIC, regulators consult with each other, share information, and develop effective policies. In the past year alone, we have made important changes to the Model Insurance Holding Company System Regulatory Act and Regulation to provide a clearer view of the operations of financial groups and their impact on any insurers within those groups.

We have enhanced securities lending disclosures requiring additional transparency in an area that received attention during the crisis. We have also reduced regulatory reliance on credit ratings by changing how commercial and residential mortgage-backed securities are valued for determining risk-based capital.

In addition, NAIC is a founding member of the International Association of Insurance Supervisors, IAIS, which represents 140 countries of insurance regulators.

It is at the IAIS Financial Stability Committee that approaches are being developed now to evaluate insurers and determine whether such entities will be considered Globally Systemically Important Financial Institutions, or G–SIFIs.

Congress recognized that insurance is regulated primarily at the State level, and for that reason the Act mandates that an insurance regulator be appointed to FSOC through a process determined by all of the insurance regulators.

We also believe Congress intended for my position to represent the interests of the entire insurance regulatory system. The important role that Congress intended for State insurance regulators to play is further supported by Section 111(b) of the Act, which provides specifically for FSOC to appoint special advisory committees of State regulators to assist it in carrying out its mission.

While FSOC engages in work that could impact insurers, two of our three insurance representatives, the Director of the Federal Insurance Office and a presidential appointee with insurance experience, are absent from the table. And I have been prohibited from utilizing available State regulatory resources, including engaging other State regulators.

Clearly, today there is inadequate insurance expertise on FSOC. Our regulatory system requires regulators to work collaboratively and share information with one another in confidential settings. Yet to date, I have been restricted with consulting with my fellow insurance regulators.

Quite simply, FSOC should want and the U.S. taxpayers should demand the resources and expertise that their regulators can provide to FSOC's work in protecting the U.S. financial system.

From the beginning, the State regulators and the NAIC have been and continue to be willing to contribute to FSOC's work relating to insurance. While we have made some limited progress with the U.S. Treasury Department on this issue, I am frustrated that it has taken so long for our concerns to be addressed.

And while I appreciate the accommodations made to date, they are simply not sufficient in light of the very important work facing FSOC. I am concerned that if progress on this front continues to be made at a similarly slow pace moving forward, decisions impacting insurance companies, insurance consumers, and our country's financial stability will be made without the benefit of nearly 140 years of proven insurance regulatory experience.

Thank you again for the opportunity to testify before you, and I look forward to answering your questions.

[The prepared statement of Mr. Huff can be found on page 72 of the appendix.]

Chairman NEUGEBAUER. Thank you, Mr. Huff.

Ms. Liang?

STATEMENT OF J. NELLIE LIANG, DIRECTOR, OFFICE OF FINANCIAL STABILITY POLICY AND RESEARCH, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM (FED)

Ms. LIANG. Chairman Neugebauer, Ranking Member Capuano, and members of the subcommittee, thank you for the opportunity to testify on the Federal Reserve Board's role as a member of the Financial Stability Oversight Council.

The FSOC members represent a number of regulatory agencies that oversee a broad range of participants in the U.S. financial market. The Chairman of the Board of Governors of the Federal Reserve System is a voting member of the FSOC. I am here testifying on behalf of the Chairman as the Director of the Board's Office of Financial Stability Policy and Research.

The Dodd-Frank Act charged the FSOC with the important task of identifying and mitigating risk to the stability of the U.S. financial system. The Council is well-placed to address risk that might not fall clearly with the jurisdiction of a single agency.

To execute its duties effectively and efficiently, the Council has established a structure to leverage the existing expertise of the member agencies to promote the sharing of information to identify risk and to facilitate coordination with respect to policy development, rulemaking, reporting requirements, and other actions.

The Federal Reserve is committed to working with the FSOC and other Council members to strengthen systemic oversight. We are helping to develop the analytical framework and procedures to identify systemically important non-bank firms and financial market utilities and for systemic risk assessment.

We are contributing to numerous studies and rulemaking and are meeting regularly with staff of the other agencies to discuss emerging risks to financial institutions and markets.

In addition to the Federal Reserve's role as a member of the FSOC, the Dodd-Frank Act gives the Federal Reserve other new, important responsibilities. These responsibilities include supervising non-bank firms that are designated as systemically important by the Council and supervising thrift holding companies.

They also include developing enhanced prudential standards, including capital, liquidity, stress tests, single counterparty credit limits, and living will requirements for the largest financial firms.

The Federal Reserve has made some internal changes to better carry out its new responsibilities. To strengthen supervision of the largest, most complex financial firms, we created the Large Institution Supervision Coordinating Committee, a centralized multidisciplinary body.

Relative to previous practices, this new structure makes greater use of horizontal or cross-firm evaluations of the practices and portfolios of firms.

It relies on additional and improved quantitative methods for evaluating the performance of firms. And it more efficiently employs the broad range of skills of the Federal Reserve staff, for example, in the areas of economic research, financial markets, and payment systems, in addition to supervision. Similarly, we have reorganized to improve the oversight of systemically important financial market utilities.

As the Dodd-Frank Act recognizes, supervision should take into account the overall financial stability of the United States in addition to the safety and soundness of individual firms.

Our revised internal organizational structure facilitates our implementation of this macroprudential approach to do oversight.

More recently, we created an Office of Financial Stability Policy and Research to better coordinate our financial stability work. This office contributes to supervision of the large complex institutions. It also helps identify and analyze potential risks to the broader financial system and the economy.

Such risk could stem from, among other things, potential asset price alignment, excessive leverage, outside financial flows, and structural vulnerabilities in financial markets.

In closing, Congress has given the FSOC an important mandate, and the Federal Reserve will work closely with our fellow regulators, the Congress, and the Administration to help FSOC execute its responsibilities and promote financial stability in the United States.

Thank you again for inviting me to appear before you today. I would be pleased to answer your questions.

[The prepared statement of Ms. Liang can be found on page 81 of the appendix.]

Chairman NEUGEBAUER. Thank you, Ms. Liang.

Mr. Cook?

STATEMENT OF ROBERT W. COOK, DIRECTOR, DIVISION OF TRADING AND MARKETS, U.S. SECURITIES AND EXCHANGE COMMISSION (SEC)

Mr. COOK. Chairman Neugebauer, Ranking Member Capuano, and members of the subcommittee, good morning.

I am Robert Cook, Director of the Securities and Exchange Commission's Division of Trading and Markets.

Thank you for the opportunity to testify today on behalf of SEC Chairman Schapiro regarding the progress of the Financial Stability Oversight Council.

As you know, FSOC was created by Title I of the Dodd-Frank Act. Its duties include identifying and designating certain non-bank financial companies as systemically important financial institutions, or SIFIs, for heightened prudential supervision by the Federal Reserve Board, identifying and designating financial market utilities, or FMUs, that are or are likely to become systemically important, monitoring the financial markets and regulatory framework to identify gaps, weaknesses and risks and making recommendations to address those issues to its member agencies and Congress, and combining the information of its member agencies in working with the Office of Financial Research to facilitate the collection and sharing of information about risks across the financial system.

Since passage of the Act, FSOC has taken steps to create an organizational structure, coordinate interagency efforts and build a foundation for meeting its statutory responsibilities to begin defining and implementing the process.

To identify and designate SIFIs for heightened supervision by the Federal Reserve Board, FSOC created an interagency committee and several staff committees.

Last October, FSOC requested initial comments on the designation process, and in late January issued a Notice of Proposed Rulemaking (NPR). The rule proposes the various factors and attributes of firms that will be considered by FSOC as part of designation determinations as well as processes and procedures established under the Act for such determinations.

FSOC also established another interagency committee to develop a framework for the designation of systemically important FMUs. These entities form critical links among marketplaces and intermediaries that can reduce counterparty credit risk among market participants, create significant efficiencies in trading activities, and promote transparency in financial markets.

However, FMUs by their nature create and concentrate new risks that could affect the stability of the broader financial system. To address these risks, the Act provides important new enhancements to the regulation and supervision of FMUs designated as systemically important.

Accordingly, FSOC sought comments last December regarding the designation process and in March published a Notice of Proposed Rulemaking to provide further information on the process it proposes to follow when reviewing the systemic importance of FMUs.

In addition to initiating work on the identification of SIFIs and systemically important FMUs, FSOC has established a Systemic Risk Committee that seeks to identify, highlight, and review possible risks that could develop across the financial system.

Beyond the work of these interagency committees, FSOC has prepared and issued two studies, including its study and recommendations regarding the implementation of Section 619 of the Act, commonly referred to as the Volcker Rule.

That study recommends the creation of rules and a supervisory framework that would effectively prohibit proprietary trading activities by covered banking entities, while appropriately distinguishing statutorily permitted activities, such as market making and risk-mitigating hedging. In addition, the study identified potential challenges in delineating prohibited activities from permitted activities.

While FSOC has made substantial progress in taking up its new responsibilities, its efforts are ongoing and the most challenging issues lie ahead, including the potential designation of SIFIs and FMUs.

Continued public input, both generally on this process and specifically with respect to the notices of proposed rulemakings, will be critically important. In addition, as Dodd-Frank implementation proceeds, sustained coordination of the FSOC agencies remains a vital consideration.

I look forward to continuing to work closely with Congress as implementation continues, and I am happy to answer any questions you may have.

[The prepared statement of Mr. Cook can be found on page 52 of the appendix.]

Chairman NEUGEBAUER. Thank you, Mr. Cook.
Mr. Murton?

STATEMENT OF ARTHUR J. MURTON, DIRECTOR, DIVISION OF INSURANCE AND RESEARCH, FEDERAL DEPOSIT INSURANCE CORPORATION (FDIC)

Mr. MURTON. Chairman Neugebauer, Ranking Member Capuano, Ranking Member Frank, and members of the subcommittee, I appreciate the opportunity to testify today on behalf of the FDIC on the issue of the Financial Stability Oversight Council, known as the FSOC.

The recent financial crisis exposed shortcomings in our regulatory framework for monitoring and addressing risk in the financial system. Before the crisis, regulatory agencies tended to focus narrowly on the institutions and markets within their jurisdiction.

We regulators did not pay enough attention to crosscutting developments that contributed to the buildup of significant risk within the system.

In addition to regulatory gaps, the absence of a resolution process for systemically important financial institutions left regulators with limited options for addressing problems facing such firms.

This created a no-win dilemma for policymakers—bail out these companies or expose the financial system to the destabilizing effects of applying the bankruptcy process to financial firms that are not well-suited for it.

My colleagues on the panel have already covered many of the key aspects of the FSOC. Therefore, I will focus my remarks on a few points of particular importance to the FDIC.

As others have mentioned, an important responsibility of the FSOC is to determine whether a non-bank financial company should be designated as a systemically important financial institution, or SIFI.

Designated firms will be supervised by the Federal Reserve and subject to prudential standards and to new requirements for developing and maintaining resolution plans. From the FDIC's perspective, the requirement that SIFIs have resolution plans is an important reason why we must get the SIFI designations right.

The purpose of these resolution plans, often known as living wills, is to ensure that if one of these firms were to face failure, it would be possible to liquidate the firm under the Bankruptcy Code in an orderly way.

The FDIC and the Federal Reserve Board have the joint responsibility for rulemaking and oversight of resolution plans. Within the last few weeks, the Boards of the FDIC and the Federal Reserve have approved a joint proposal for comment.

Once these rules are in place, if the resolution plans submitted by the firms are not found to be credible, we can require change which could ultimately result in downsizing and simplification of these firms.

Resolution plans and the FDIC's Orderly Liquidation Authority (OLA) are critical features of the Dodd-Frank Act because they will provide future policymakers with a means of handling the failure of a large, interconnected financial firm in a way that does not de-

stabilize the financial system and does not bail out creditors and investors.

It is important that we put these rules in place effectively so that market participants will know they are at risk when they invest in or lend to large, systemically important financial firms.

This will ensure that these firms are subject not only to regulation and supervision, but also to meaningful market discipline. Both are necessary for the financial system to safely and efficiently allocate the capital and credit necessary to support economic growth.

Thank you again for the opportunity to testify. And I would be happy to answer any questions.

[The prepared statement of Mr. Murton can be found on page 102 of the appendix.]

Chairman NEUGEBAUER. Thank you, Mr. Murton.

Mr. Long?

STATEMENT OF TIMOTHY W. LONG, SENIOR DEPUTY COMPTROLLER, BANK SUPERVISION POLICY, AND CHIEF NATIONAL BANK EXAMINER, OFFICE OF THE COMPTROLLER OF THE CURRENCY (OCC)

Mr. LONG. Thank you, Chairman Neugebauer, Ranking Member Capuano, and members of the subcommittee.

My name is Tim Long. I am Senior Deputy Comptroller and Chief National Bank Examiner at the Office of the Comptroller of the Currency. In this role, I serve as OCC's representative on the Financial Stability Oversight Council's Deputies Committee. I appreciate the opportunity to provide the OCC's perspective on the functions and operations of the FSOC.

Congress set forth very specific mandates regarding the role and function of FSOC, but its primary mission is threefold: to identify risks to the financial stability of the United States; to promote market discipline; and to respond to emerging threats to the stability of the U.S. financial system.

In some cases, the Council has a direct responsibility to make decisions and take action. This includes designating certain non-bank financial companies to be supervised by the Federal Reserve and subject to heightened prudential standards should the Council determine that material financial distress at such companies would pose a threat to the financial stability of the United States.

In other areas, the Council's role is more of an advisory body to the primary Federal regulators, such as conducting studies and making recommendations to inform future agency rulemakings.

The OCC believes the very roles and responsibilities that the Congress assigned to the Council appropriately balance and reflect the desire to enhance regulatory coordination for systemically important firms and activities, while preserving and respecting the independent authorities and accountability of the primary supervisors.

As detailed in my written statement, and as the other witnesses have described, FSOC has taken action on a number of items, including the publication of two required studies and proposed rulemakings on the designation of systemically important non-bank financial firms and financial market utilities.

The Council and its committees are also making strides in providing a more systemic and structured framework for identifying, monitoring, and deliberating a potential systemic risk to the financial stability of the United States.

Briefings and discussions on potential risks and the implications of current market developments on financial stability are a key part of the closed deliberations of each of the Council meetings.

In summary, I believe FSOC enhances the agencies' collective ability to identify and respond to emerging systemic risk.

I would, however, offer two cautionary notes. First, I believe the Council's success ultimately will depend on the willingness and the ability of its members and staff to engage in frank and candid discussions about emerging risks, issues and institutions.

These discussions are not always pleasant as they can challenge one's longstanding views or ways of approaching a problem. But being able to voice a dissenting view or assessment will be critical in ensuring that we are seeing and considering the full scope of issues.

In addition, these discussions will also involve information or findings that will need further verification, that are extremely sensitive, either to the operation of a given firm or market segment, or, if misconstrued, could actually undermine public and investor confidence and thereby create or exacerbate a potentially systemic problem.

As a result, I believe that it is critical that these types of deliberations, both at the Council level and at our staff level, be conducted in a manner that ensures their confidential nature.

Second, even with the fullest deliberations and the best data, there will continue to be unforeseen events that pose substantial risk to the system, markets or groups of institutions. Business and credit cycles will continue.

We should not expect FSOC to prevent such occurrences. FSOC will, however, provide a mechanism to communicate, coordinate, and respond to such events to help contain and limit their impact.

The issues that the Council will confront in carrying out these duties are, by their nature, complex and far-reaching in terms of their potential effects on our financial markets and the economy.

Developing appropriate and measured responses to these issues will require thoughtful deliberation and debate among the member agencies. The OCC is committed to providing its expertise and perspective in helping FSOC achieve its mission.

Thank you, and I will be happy to take questions.

[The prepared statement of Mr. Long can be found on page 88 of the appendix.]

Chairman NEUGEBAUER. Thank you, Mr. Long.

It is the intention of the Chair, and I talked to the ranking member, that we try to conclude this hearing prior to the—we think we are going to have a series of votes around 12:30.

Now, what that means is we have a number of people in the queue here who want to ask questions, and I want everybody to have an opportunity to ask a question, because it is not fair to some of the members, and then we get right to the end, and they have waited here all day and didn't get to ask a question.

The Chair is going to hold pretty strictly to the 5-minute rule for members. So keep that in mind and get to your best question first. And I ask the panel members to be as succinct as they can so that members will have an opportunity to ask as many questions as they can.

I will start the questioning. I think one of the things that I think that the Council states publicly on its Web site, as I said in my opening statement, too, is that it is committed to conducting its business in "an open and transparent manner."

Yet, we understand that there are an internal memo, in fact, my staff member went over and reviewed an internal memo that is about 80 pages, that has some very specific information in there about a process that is under way to determine some of these non-bank financial institutions and the criteria for them, particularly when it comes to insurance companies.

The memo says, "to the extent to which large insurers could be subject to orderly resolution of the market share of MBS and CMBS held by the insurer, a number of demand accounts held by the insurer." And so then when, I look at the original document put out for rule, it basically just restated what is in Dodd-Frank.

And so, Mr. Goldstein, I wonder if we are going down a process here of being transparent, and as important as the criteria is to this process, it may be one of the most important pieces of it, that it doesn't appear that we are being very transparent.

What we are hearing from people who are trying to respond back to that is they got the same response. If you reprint Dodd-Frank, it is the same response that they had to Dodd-Frank. I think what they were looking for—I think what we are looking for is a little bit more transparency and meat in this process. Can you respond to that?

Mr. GOLDSTEIN. Yes, Mr. Chairman, I will. Thank you very much. It is a very important question because I think that FSOC has committed itself to transparency and to clarity.

The very first meeting of the FSOC in October put out an advance notice of public rulemaking. In addition—that received 50 comments, 50 important comments.

In January, a notice of public rulemaking was put out which received approximately 35 comments, and those comments are being taken very seriously.

The process is one which is also meant, as I mentioned in my testimony, to be highly transparent, to be firm-specific and the designation process will invite firms to provide comments that can be utilized in making a determination.

If a firm wants a hearing, that hearing will be provided. And in addition to that, there will be a requirement for transparency under the statute to ensure that Congress is informed of the basis for designation.

I think that the comments, as I mentioned in my testimony, have asked for greater clarity. And in the final rule text, we expect to provide greater clarity.

What was put out was an attempt to try to take the 11 criteria that were in the Act and try to map them into two broad buckets.

Bucket one is, what would be the implications of failure for an institution? For example, what is its interconnectivity? What is its

size? What are the—does a firm have substitutes that other firms can provide? So what are the implications for the system of failure?

The second broad bucket was a bucket of, what are the vulnerabilities of that specific firm? So for example, maturity mismatch, liquidity, leverage, extent of existing regulatory scrutiny. And all of this was informed by the statute. We are advancing that work and would continue to advance that work.

You made reference to a report. I would just spend one moment emphasizing that the report was a draft report that was meant to help inform staff on the designation process. It never made its way to deputies. It has never made its way to principals. It was an early-stage document.

And so I wouldn't want to suggest to you that there was an FSOC document that had been reviewed, validated, and did not make its way into the public domain.

Chairman NEUGEBAUER. Got it, just a quick follow up. When the criteria comes out in the final rule, there will be no further opportunity for comment, though. Is that correct?

Mr. GOLDSTEIN. I think we have received, as I said, 50 comments from the ANPR. We received 38 comments—

Chairman NEUGEBAUER. Yes or no, when the final rule comes out, there is no opportunity for final comment? Is that correct?

Mr. GOLDSTEIN. That would be my understanding.

Chairman NEUGEBAUER. And so what we have sent out is a very general, broad framework, and people—the reason, I think one of the reasons you have gotten very few responses is that people really don't know what to comment on.

I think what we owe in this process, and I am extremely disappointed that we didn't come out with specific criteria that the working group is thinking about and let people comment on that.

Now what you have done is you have taken very general comments and you are going to huddle up, make the final decision, and nobody is going to have any input into that. And quite honestly, that is not transparency to me.

With that, I recognize the ranking member, Mr. Capuano.

Mr. CAPUANO. Thank you, Mr. Chairman. I was actually going to ask the same question.

And I will be very clear. I don't like that answer, and I don't like that situation. I think it is totally—I think everything you have done so far is fine. But to come out with a final regulation with specific criteria that doesn't allow anybody an opportunity to respond to or comment on, I think that is unfair. And I don't think that is transparent by any fair definition of the term.

I am not prepared to argue with anything you have done thus far, and I am not prepared at all to argue with whatever criteria you may choose. But to then choose it, when we are into a whole new world, particularly when it comes to insurance and other nonbank, we have never regulated some of the people we are about to regulate.

I think it is only fair to give them an opportunity to respond and say, "Well, maybe you shouldn't count this or maybe you should count that." Not that you have to agree, but at least an opportunity for an open dialogue. That is my definition of transparency.

I want to be very clear that I do not like that situation or that answer, and I would strongly request that the members of the FSOC reconsider that approach, again, not for the conclusion or the result, but in deference to true transparency and fairness.

I guess that actually answers most of the questions I have, to tell you the truth. That is where I was going to go is, what is going to be public, how are they going to know?

But I do want to ask another question. When you finally get to the point of designating somebody, when will that become public? When will my wife know that firm XYZ has now been designated as a SIFI? Will that be at the end of the process? Because, as I understand it, even once you designate somebody, there will then be some give and take, some appeals process.

When will that happen that it becomes public? Will it be at the beginning when you initially designate, or at the end, when they have finalized their opportunities to appeal and consider the matters? Do you know yet?

Mr. GOLDSTEIN. I think the designations process is meant to be, as I said, open in the following sense. It is meant to provide an opportunity to any firms that would like to provide information relevant to its designation. That firm could, subject to its own decision—

Mr. CAPUANO. I understand that—

Mr. GOLDSTEIN. —put it in the public domain.

Mr. CAPUANO. —but what is the intent at the moment?

Mr. GOLDSTEIN. I think the intent of the FSOC, as I currently understand it as, would be to not make a designation public until it went through the totality of the process.

Mr. CAPUANO. Good. I think that's a fair approach.

Mr. GOLDSTEIN. And that would be after a two-thirds vote of the Council. But it would not be anticipated—

Mr. CAPUANO. So the two-thirds vote of the Council wouldn't come until after they have had an opportunity to respond?

Mr. GOLDSTEIN. Yes, sir.

Mr. CAPUANO. That is a fair approach.

I guess I would like to know, in general, from everybody, what do you think of the concept of originally starting with a smaller list so that you can kind of walk before you run?

And then the concept of obviously having a larger list that would be kept by somebody, in my opinion preferably private, for the companies that either are going to game the system or might potentially become significant.

I am just curious. Is that the general approach that is being considered, or is somebody still fighting to have a humongous list right to begin with?

Ms. LIANG. I can address some of that, building on what Mr. Goldstein said. Designation is not a simple process, and it is not a one-size-fits-all process approach.

There are multiple factors in the statute that we have been asked to consider, in contrast to banks, where Congress chose a $50 billion cutoff. And as Jeffrey mentioned, there is a process for a notice, hearings, review.

So we are collecting information and we are trying to consider all the comments that we have received. We need to consider this carefully and thoughtfully.

Mr. CAPUANO. I respect all that, but is the intention to consider it thoughtfully and thoroughly with 4,000 organizations or with 100? I fully respect everything you just said, but it still doesn't answer the question.

Mr. GENSLER. I guess I will just—speaking as one voting member of the Council, I should hope that we do something similar to what the ranking member said, that the Council staff be looking at in each of these industry groups a small group. But I think it is the clear intent of Congress that this is a small group that are truly systemically relevant institutions.

Mr. CAPUANO. And I think that is obviously the right way to go, but I am also—and my time is almost up—I am very concerned about only looking, for the sake of discussion, at 50 groups, 50 entities to begin with, but missing those next 200 that might become significant tomorrow or might merge the next day.

And if you haven't looked at them going forward, then the minute they become significant, you will have known nothing about them. And I am hoping that there is a thoughtful process by having an ongoing review of that.

Chairman NEUGEBAUER. I thank the ranking member.

Mr. Fitzpatrick?

Mr. FITZPATRICK. Thank you, Mr. Chairman.

Mr. Goldstein, in her testimony, Ms. Liang mentioned that it is an important thing that the U.S. financial firms be coordinated with international efforts to implement the Dodd-Frank Act and that they are well-aligned with the efforts of the G-20, the Financial Stability Board and Basel.

This is, I believe, an important part of the duties of FSOC, and I am curious why this was not mentioned in your testimony. I will give you a chance to elaborate on that.

Mr. GOLDSTEIN. The omission from my testimony does not in any way diminish the critical importance of the point you have just made. I think that it is the responsibility of FSOC and the member agencies to look at all of the relevant issues through an international lens.

And I think that looking at the work of the Council and its member agencies is meant to ensure that outreach takes place on individual issues and collectively and that it, in fact, is taking place.

It is incredibly important that we seek wherever possible international consistency, and I would be in full agreement with you on that point, sir.

Mr. FITZPATRICK. So what type of coordination do you foresee?

Mr. GOLDSTEIN. I think that there is coordination that takes place at multiple levels. Many of the members of the FSOC are participants in the Financial Stability Board. Many of them are, of course, part of the Basel process.

In addition to that, many of the members of the FSOC engage with their European and other counterparts on issues related to derivatives, which I am sure Mr. Gensler can speak to, on issues across the spectrum. And so it is done at the individual agency level, and it is also done at an FSOC level wherever appropriate.

Mr. FITZPATRICK. Mr. Secretary, one key position on the Council remains unfilled and that is a person with the insurance background and expertise. Can you indicate for the subcommittee when this position will be filled?

Mr. GOLDSTEIN. I am not in a position to speak for the President of the United States. This is a presidential nomination subject to the confirmation of the Senate. It is my understanding that people are hard at work on this issue.

I think we do have the benefit in the interim of Mr. Huff, who is a State insurance member. And we also have named Michael McRaith to head the Federal Insurance Office, who brings with him extensive State insurance expertise. He is currently the Illinois insurance commissioner.

Mr. FITZPATRICK. So you feel it is appropriate to go forward with Section 113 designations without that permanent position being filled at this point?

Mr. GOLDSTEIN. I think we have extensive insurance expertise in Mr. Huff and Mr. McRaith, but I think, as I said earlier, we are not at the point of making designations today. We are in a deliberative process and so I would not anticipate that designations will be forthcoming in a very short time horizon.

Mr. FITZPATRICK. If Mr. Huff wanted to bring on additional staff and regulatory consultants, bring them on board tomorrow, would you let him do that?

Mr. GOLDSTEIN. Mr. Huff has, like all FSOC members, the ability to utilize fully his own agency. And that is true across all of the FSOC members. In addition to that, he requested additional personal support to utilize people from outside of the public sector.

The FSOC discussed and has worked with Mr. Huff to be able to make sure that those people who are outside of the public sector are covered by appropriate confidentiality constraints. And that is true of all FSOC members, meaning all FSOC members have the ability to lean on their own staffs and utilize their own staffs, and are subject to confidentiality constraints given the sensitive nature of the work done by the FSOC.

We will continue to work with Mr. Huff. We are trying to balance in our discussions at the FSOC the need that Mr. Huff has, but also the critical confidentiality, given that the FSOC is exposed to confidential supervisory information, confidential trade information.

But I would also add that there should be no limitation, nor has any limitation been imposed on Mr. Huff consulting without the utilization of that confidential information.

Mr. FITZPATRICK. Is that a yes? Can he bring them on board?

Mr. GOLDSTEIN. We will continue to work with Mr. Huff to make sure that he has appropriate support.

Mr. FITZPATRICK. Thank you.

Chairman NEUGEBAUER. I thank the gentleman.

And now the ranking member of the full committee, Mr. Frank from Massachusetts?

Mr. FRANK. Mr. Goldstein, I am going to continue that line. We worked very hard in writing the bill to make sure that the insurance industry was given representation. There is a delicate balance there because it is State-regulated, but we are going to be making

decisions that could affect them. Please err on the side of inclusion. Let us not get too bureaucratic.

And Mr. Huff talked about State insurance commissioners. When you say "public sector," would that exclude State insurance commissioners? Are you talking—is that shorthand for the Federal public sector? What about if he wanted to work with some State insurance commissioners? Would they be covered?

Mr. GOLDSTEIN. What we have tried to do—

Mr. FRANK. Quick. No, State insurance commissioners, could he deal with them? Would they be—because they are public sector people whom I assume better be confidential or there is real trouble with the State. Would there be a problem with him working with them in this work?

Mr. GOLDSTEIN. I think what we would need to do is—

Mr. FRANK. You need to answer my question, Mr. Goldstein.

Mr. GOLDSTEIN. What I would like to do, sir, is to just try to balance the—

Mr. FRANK. No, Mr. Goldstein, I am sorry. You are not answering the question. I don't understand. Let us not have a lot of Federal, State, "we will pursue this" kind of jealousies here.

We worked hard to balance a lot of concerns, including representation of the insurance industry. It is not your fault that the appointments haven't been made yet, but you have to take that into account.

Let me go on now. I was very disappointed that Mr. Bachus engaged, I thought, in a kind of partial quotation. He quoted Mr. Tarullo as saying, "There was a reasonable concern that designating a small number of non-bank affiliates would increase moral hazard concerns."

He forgot, I guess. He didn't get that far, and he got interrupted. In the next paragraph, Mr. Tarullo says, "Any moral hazard that might be created by the designation process should be substantially offset by the specially applicable supervisory and regulatory requirements" to which I now turn.

In other words, yes, some people were afraid that being designated would be this badge to go out and collect money, but Mr. Tarullo says in that same speech, he couldn't have had to read that much longer, "We will offset that because you are subject to requirements."

And the fact is, and I want to ask people, the judgment of those who could be covered and could not be covered, who fall in that discretionary path, appears to be that the benefits of being covered are far outweighed by the hindrance of being covered.

That is, they don't see it as a moral hazard in the sense that this would enhance their ability to attract counterparty funds. They think it is a pump.

So let me ask you, the people here at the FSOC, without getting into companies, although some have been mentioned, and the press overwhelmingly reports that the companies are lobbying you not to be included, meaning they do not see the benefit of being the beneficiaries of moral hazard. They see the offsets that Mr. Tarullo mentioned.

Would several members tell me, have you been lobbied by people trying to be excluded from designation, Mr. Goldstein?

Mr. GOLDSTEIN. Yes.

Mr. FRANK. Let me ask at the Fed and the FDIC, at the Fed, have you been lobbied by people who don't want to be included?

Ms. LIANG. Yes.

Mr. FRANK. FDIC?

Mr. MURTON. Yes, we have.

Mr. FRANK. Comptroller?

Mr. LONG. No, we haven't.

Mr. FRANK. SEC?

Mr. COOK. Yes.

Mr. FRANK. Yes, what was that?

Mr. COOK. Yes.

Mr. FRANK. Yes, okay. The Comptroller, of course, wouldn't be because you only do banks and so they don't have the discretion.

So all those where there is discretion have been lobbied by people who don't want to be covered, suggesting that this supposed advantage of being too-big-to-fail doesn't exist in the eyes of those supposed beneficiaries.

Let me ask you, have any of you been lobbied by people who want to be covered?

Mr. GENSLER. No.

Mr. FRANK. Let us go down the list.

Mr. GOLDSTEIN. No.

Mr. LONG. No.

Mr. HUFF. No.

Ms. LIANG. No.

Mr. FRANK. No, out loud, no, no.

Mr. LONG. No.

Mr. COOK. No.

Mr. MURTON. No.

Mr. FRANK. All right. I think that pretty conclusively answered this question. And in fact, we had this inaccurate characterization that they are going to be too-big-to-fail and the taxpayers will be forced to cover—absolutely untrue.

In the statute, it says yes, there are institutions that may be too-big-to-fail and have that failure be ignored. There may be institutions that are too-big-to-fail without negative consequences, although, as Mr. Tarullo mentioned, as we all say in the war, there are efforts here to do things that will keep that from happening.

But if they do, if they do fail, they go out of business so no institution survives. That is where Sarah Palin's death panels show up in our bill, not in the health bill. It is for large financial institutions.

And secondly, any money that is used to pay some of the debts, not all of the debts, has to be recouped from the large financial institutions that are covered by this. So let us lay this to rest.

And again, the financial institutions themselves have answered the question, is there some benefit to being designated? Everyone here has said they have been lobbied by people who don't want to be designated. And nobody has been lobbied by people who want to be designated, so we ought to be able to put that one to rest.

Finally, on the competitive side, I repeat again, the British banks were worried that they were going to be too tough. You were asked

why you didn't talk more about the competitive issues. Are the competitive issues entering into your conversations?

Let me ask the Federal Reserve. Have you been concerned about the competitive issues internationally?

Ms. LIANG. We are working with our international counterparts in trying to promote financial reform, moving roughly in the same direction.

There are a few issues in Dodd-Frank that raise competitive issues. We put those out in studies. We have noted those concerns and asked for comments, and are considering those as we are—

Mr. FRANK. Very appropriate.

Ms. LIANG. —following the statute.

Mr. FRANK. Thank you.

Thank you.

Chairman NEUGEBAUER. I thank you.

And now the gentleman from New Mexico, Mr. Pearce?

Mr. PEARCE. Thank you, Mr. Chairman.

Mr. Gensler, I am happy to see on page two that you are saying that we need to ensure protections for the American public where investors and savers can get return on their money. If you get that part of the report out really quick, you have a lot of retirees out there who are getting one-quarter of 1 percent.

I don't know if that qualifies as a return on their investment, but many of them have lost 25 percent, maybe 50 percent of their core savings. And so if the government is going to insure these things, I think the American people would really appreciate us getting to it.

Mr. Goldstein, Mr. Gensler refers to AIG and then he refers, on page two of his report that taxpayers should not be forced to stand behind institutions and then there are a variety of institutions. And you yourself mentioned something to that effect.

Now, when we look at insurance, and we look at failures of insurances, the first one that we have to think about is the Flood Insurance Program.

And so I wonder if you all are going to—if you think it is proper that the American public is being asked to stand behind the Flood Insurance Program, and we are doing that, first of all, through taxpayer dollars, but then, secondly, we are forcing the fees into homes that were not previously required to have flood insurance, many in New Mexico.

Our elevation starts at 4,000, basically 4,000 feet above sea level. That is where New Mexico starts. We start pretty high in the atmosphere, and yet we are being required to pay for those. Is that a proper thing, and is that something that you are going to look at?

Mr. GOLDSTEIN. Sir, this is not an issue that I am well-versed in, and I would be happy to come back to you and work with my staff and—

Mr. PEARCE. But you would generally say you agree that taxpayers or people who receive new fees which are indeed a tax might not should have to stand behind programs that are in the process of failing? Is that more or less correct?

Mr. GOLDSTEIN. I am not familiar with it, sir. I apologize.

Mr. PEARCE. No, this is a generality, that taxpayers should or should not stand behind? You were just saying that the taxpayers, in the previous line of questioning, taxpayers are not going to be required to pick up the tab. And is this, or should they or should they not be?

Mr. GOLDSTEIN. I think that the context of the Dodd-Frank legislation makes abundantly clear that taxpayers should not be at risk for those—

Mr. PEARCE. So you are going to take a look at the Flood Insurance Program, where taxpayers are having to bail out a program that has failed, a program that is originating from the same government that is saying now it is going to stop all failures in the future. I find that curious. But you are going to take a look at that?

Mr. GOLDSTEIN. Yes, sir.

Mr. PEARCE. Okay, I appreciate that.

You mentioned that every designation, in page five of your testimony, that every designation is going to be firm-specific. When you tell me that every designation is going to be firm-specific, that is almost—that goal is rated to people and taxpayers who are trying to ensure that they get a return on their investment would look at that list of institutions and say, well, the Federal Government has declared that they looked at this as firm-specific, and yet you are not going to give any implicit guarantees.

I find myself believing that there are going to be beliefs in the minds of people that are the same. In other words, GSEs never had a guarantee. It was just sort of implicit. The government had, sort of, taken a position on it.

And so, to find that you are firm-specific giving designations, and then you are not going to stand behind it, which was, I think, the context of the "No, no, no, noes," I find that to be a curious position.

Could you clarify that briefly? We have a lot of questions still behind us, and—

Mr. GOLDSTEIN. I think the purpose of Dodd-Frank was to help ensure that no large interconnected institution that could do damage to the U.S. financial system would be outside of effective supervision, would be able to operate without appropriate prudential standards, and would ensure that the large financial institutions would—

Mr. PEARCE. Let me get to my last question. I am not, kind of, hearing an answer there. But I would appreciate it.

The last question is that you yourself say that there are failures of the regulatory system. And then Mr. Gensler also refers to the financial system failing and the regulatory system failing.

So you have created this new agency. Are you in the process of dismantling the systems that failed, or are we just going to continue to fund those? We are spending $3.5 trillion right now, and we are bringing in $2.2 trillion, so we are deeply out of balance. We need to find ways to save money in the government, ways that don't take money away from end users.

So this system failed, and it is being replaced by a new system. Is the old system being dismantled and defunded?

Mr. GOLDSTEIN. I think what Dodd-Frank does is create—

Mr. PEARCE. No, I am asking—you all have the jurisdiction. Are you all dismantling the pieces that failed? You said they failed. Just a yes or no would be—

Mr. GOLDSTEIN. We do not have jurisdiction to change independent regulatory agencies, sir, if that is your question. And maybe I have misunderstood.

Mr. PEARCE. So you all are not realigning the oversight, or somebody is not realigning the oversight of the financial system? I think they are, and I don't think we are doing the legislation.

Thank you, Mr. Chairman.

Chairman NEUGEBAUER. I thank the gentleman.

And now the gentleman from Massachusetts, Mr. Lynch?

Mr. LYNCH. Thank you, Mr. Chairman. I want to thank all the witnesses for your attendance here.

Recently, after a long legal battle over an information request, a FOIA request by Bloomberg financial company, Chairman Bernanke was forced to disclose the details of his lending practices during the peak of the crisis.

He fought very hard to keep that information secret from Congress and from the public. As it turns out, at the peak of the banking crisis, 70 percent of the lenders who came to the discount window at that time and 70 percent of the loans—excuse me—were foreign banks.

Many of them had very little business here in the United States, but the top 6 institutions that requested loans, discount loans, backed by the Federal Reserve, totaled $274 billion. They got loans from the Fed for $274 billion. And they tried to keep that secret from the American people.

Part of your responsibility under Title I will be to address issues of U.S. competitiveness. Ms. Liang, since you are in the seat for the Fed, is it not counterintuitive that we would be bailing out foreign banks at a time when your responsibility is to make us more competitive in a global financial market?

We are bailing out, with American taxpayer money, or backed by the American taxpayer, we are bailing out foreign banks that we compete with. Can you try to help me reconcile that action, where we take $274 billion, give it to foreign banks, and like I said, many of them with insignificant activity directly here in the United States, yet we are bailing them out? Can you help me with that?

Ms. LIANG. Congressman, we have a statutory requirement that branches and agencies of foreign banks have access to the discount window under the same conditions as domestic banks.

These are loans. They are not gifts. They are fully collateralized. They are subject to the same haircuts as domestic institutions would receive.

Mr. LYNCH. I just want to point out, though, that the vast majority here went—70 percent. So we are not talking about at the same level of support for domestic banks. We are talking about 70 percent of the loans going to—that is not equal. That is heavily favoring foreign banks.

Ms. LIANG. I can only speak to—

Mr. LYNCH. And I am not sure that the statute requires us—they may be eligible for support, but that is a discretionary function of the Fed, whether to loan the Dexia Bank in Belgium $33 billion or

to loan Depfa Bank in Ireland—I think theirs was $28 billion. I might be wrong on that number, but it was considerable, and there is $274 billion.

So what I am asking you is, you have a responsibility here, and I just see some inconsistency, if you don't mind, where we are supposed to compete with folks, yet we are using U.S. taxpayer-backed funding to bail them out. And it bothers me to no end, number one, but, number two, I just don't see the consistency in that policy.

Ms. LIANG. We provide—

Mr. LYNCH. And if anybody else would like to jump in and explain this, go right ahead, because maybe I am asking the wrong person.

Ms. LIANG. We set the terms and standards to be the same. We do not determine the volumes at which they might want to borrow.

Mr. LYNCH. I am sorry. I am having a hard time hearing you.

Ms. LIANG. We set the terms and standards. They are the same as would be available to domestic institutions. We do not determine the amount that they borrow.

The foreign entities play a pretty big role in the United States in credit provision in the United States. For example, the firm Dexia that you referred to is a main primary liquidity provider to municipal, State, and local governments.

So I think the foreign institutions do play a large role in the provision of credit in this country. There would be many considerations if Congress wanted to consider changing this law, in terms of international cooperation and reciprocal treatment. I think those are issues that could be discussed.

Mr. LYNCH. Okay, I believe my time has expired. Thank you, Mr. Chairman.

Chairman NEUGEBAUER. I thank the gentleman.

And now the gentlewoman from New York, Ms. Hayworth?

Dr. HAYWORTH. Thank you, Mr. Chairman.

I want to return—a couple of our colleagues have talked about the Financial Stability Board and our coordination of the regulations that FSOC is now preparing.

And I am concerned, fundamentally, with the arbitraging of regulations, the outmigration of capital from United States' markets. And I think we are already seeing that. Certainly, one of my friends who serves in the financial services industry, said that Singapore, for example, had a growth in its domestic product of 14 percent last year.

I have the sense that there is an opportunity for our counterparts internationally to hang back on creating regulations in anticipation of what FSOC will be doing so that they can then promulgate their own sets of regulations that may be more conducive to capital investment in their own country.

So how is FSOC monitoring that kind of potential development, and what tools do you have at your disposal to address those concerns, particularly if we in the Congress raise them on behalf of our constituents, on behalf of the country? What is your plan for dealing with that potentially significant problem?

Mr. GENSLER. I can speak less about FSOC as FSOC and more about just one area in Dodd-Frank, and that is the derivatives regulations. I think each of our agencies has been working very closely

with Asia and in Europe. We do it in turn. Sometimes, it is the Secretary of the Treasury, and sometimes it is the head of the SEC and the head of the Federal Reserve.

In my case, I have gone over to Europe on a repeated basis. Our staff—we are actually sharing some of the internal work product with them. It does look like Europe is going to be moving forward as Japan has already moved forward on derivatives reform. Their parliament is taking it up right now.

We also at the CFTC host between 15 and 20 countries coming in on a periodic basis where we compare and try to coordinate and harmonize. We are different cultures and different political systems. There will be differences. And, Congresswoman, you are absolutely right, there will be probably a little bit of a race to the bottom.

But I am optimistic, particularly in terms of the coordination between Europe and here, Canada and here, Japan and here, but there are some countries that will do just what you said.

Dr. HAYWORTH. Yes, sir. And I appreciate that.

By keeping in close touch with them, obviously, you are also letting them know what we are doing, so anybody who did want to compete with us in that way would have the keys to the kingdom, in a sense. But you are confident that we will be able to adapt should we detect a competitive disadvantage, if you will?

Mr. GENSLER. We at the CFTC are certainly taking it into consideration in each of our rules, then have deliberations, and then sharing that across—even when I meet with the Secretary of the Treasury, it is usually one of the topics in our regular meetings is this international aspect.

Dr. HAYWORTH. Yes, sir?

Go ahead, please.

Mr. GOLDSTEIN. I was just going to emphasize that there are multiple fora, including the G-20, including the Financial Stability Board, including Basel. And as the Secretary has stated on repeated occasions, a primary objective needs to be the setting of an international level playing field.

And so we agree with the concern that you have articulated and are trying to ensure through those fora and other mechanisms to address the important concern.

Dr. HAYWORTH. Yes, sir.

Please?

Mr. HUFF. If I could just build on that, speaking from the insurance side, because the United States is 40 percent of the worldwide insurance market, the NAIC, the insurance commissioners, are very active at the International Association of Insurance Supervisors. And we are working within that committee's structure to build the metrics for designation.

I would just add, because we have different insurance commissioners working on that and we have staff that overlap, this issue on involving insurance commissioners in FSOC does make that coordination more difficult because we need to be able to communicate with one another as we work to harmonize those international with domestic.

Dr. HAYWORTH. Clearly, that is an important concern.

So we can then assure, and you are assuring our financial market participants, our financial institutions, that they can be confident in continuing to prepare to invest capital resources in the United States because we will not allow other nations to compete successfully with us in the regulatory climate. Is that fair to say?

Mr. GOLDSTEIN. I think, as Mr. Gensler said, it is impossible to assure that there will not be some people that will try to arbitrage the system. I think what we need to do is to make sure that through global fora, we ensure and push aggressively for a level playing field. And I think that should be our objective.

I would say, however, that having a strong U.S. financial system is itself a competitive advantage. I think that what we need to do and one of the benefits of Dodd-Frank is it helps us accomplish that. The unique role of the financial system is built on its stability, and I think that should be a primary objective as well.

Chairman NEUGEBAUER. I thank the gentlewoman.

And now the gentleman from North Carolina, Mr. Miller?

Mr. MILLER OF NORTH CAROLINA. Thank you, Mr. Chairman. Sometimes the rule of law raises difficult issues in democracies. Elections should have consequences, but they should never have the consequence of either being prosecuted because your party lost an election or being excused from prosecution because your party won an election, that the criminal law should be neutral. It should not be subject to political considerations.

But the movie "Inside Job" repeated a criticism that a great many people have had with respect to the financial crisis and what followed it, that a couple 3,000 people went to jail as a result of the savings and loan crisis, and no one had gone to jail as a result of this crisis.

And I don't think the criticism was that an angry public was demanding that people be rounded up and put in jail, that we have mob rule, but that the ordinary prosecutorial judgments were, in fact, being interfered with where there would be prosecutions otherwise.

I don't want to urge prosecutions, but I do want to inquire about whether there are criminal investigations at least going on.

There is now pending, I think, in New York, but there is now pending litigation, *Ambac* v. *Chase,* that actually has to do with conduct by Bear before they were acquired by Chase, that seems clearly to give rise—these are admitted.

These are allegations, but they are allegations in an admitted complaint that does seem to include information contained in discovery, documents produced in discovery, that Bear bought mortgages from originators, immediately securitized the mortgages, sold the securities. Some of those mortgages went into default almost immediately, 30 days, 60 days, 90 days.

And what Bear did was instead of requiring the originator to buy those back, settled for attached compensation, kept the money, even though they had no beneficial interest at that point in the mortgages, they had sold them to the investors, did not pass along the money to the mortgage investors, and in fact did not tell the investors.

That appears to give rise to—it certainly sounds criminal. Other allegations were that Bear would turn over to a third party due process examiner mortgages.

They would sample the pool, 1 in 10, and then the mortgages that investigator, that due process firm said did not meet the requirements of the representations and warranties of the pooling and servicing agreements, Bear would remove those from those pools, from that pool, but then put them in another pool where they would be subject to a 1-in-10 chance of being reviewed.

Again, that sounds pretty likely to be criminal, if those allegations are true.

Mr. Cook, the SEC is one of the agencies of government that has investigatory powers in this area. I think the concerns have been not—well, perhaps to some extent that potential defendants had great political and economic power, but also there was a judgment that criminal prosecutions or even civil litigation might undermine the health, the return to health of some of those institutions. Are those allegations being pursued by the SEC, and if not, why not?

Mr. COOK. As you probably know, the SEC does not have criminal prosecutorial authority. I know you are asking really about civil authority and—

Mr. MILLER OF NORTH CAROLINA. But you refer matters for prosecution when your investigation shows possible—

Mr. COOK. It can be referred by the SEC to prosecutors. The investigations enforcement proceedings that you are talking about would be handled by our Division of Enforcement. And I am not familiar with the details of their investigations. I believe that their investigations are ongoing.

I would be happy to arrange for further updates to you, or a briefing for you on some background. I am sorry—

Mr. MILLER OF NORTH CAROLINA. Okay.

Mr. COOK. —it is just not my division.

Mr. MILLER OF NORTH CAROLINA. Okay.

And, Mr. Long, the OCC obviously has investigative powers here as well. Almost all of these institutions are regulated or are subject to the OCC. Is the OCC pursuing any of these investigations, investigating any of these allegations?

Mr. LONG. As part of our exam process and as part of our look back on incidences that we see, we certainly will embark on investigations and open criminal referrals and subpoena documents. We do that on a regular basis.

Mr. MILLER OF NORTH CAROLINA. Well, do—

Mr. LONG. I would, on this specific—

Mr. MILLER OF NORTH CAROLINA. —but do you know anything about this—

Mr. LONG. No, no, I don't.

Mr. MILLER OF NORTH CAROLINA. Okay.

All right, my time has expired, Mr. Chairman.

Chairman NEUGEBAUER. The gentleman from Florida, Mr. Posey?

Mr. POSEY. Thank you, Mr. Chairman.

I don't want to be piling on, but I want to echo the comments of you and the ranking member here about the rulemaking process. It is my understanding that in the rulemaking on systemic rel-

evance, the FSOC was not specific. And I think that lack of specificity makes it all the less transparent, as was pointed out.

Can you tell me how that is going to get corrected?

Mr. GOLDSTEIN. As I indicated, I think we have had 50 comments on the ANPR, another approximately 35 comments on the NPR, and we are trying to bring forward a rule that is highly informed by those comments, and we would share your view that greater clarity would be highly beneficial in the final rule text. And we will do our very best to help accomplish that objective, informed by the comments that we receive.

Mr. POSEY. Will it contain the metrics that you will use to analyze financial firms or how it intends to weigh the various criteria Dodd-Frank requires for FSOC to consider?

Mr. GOLDSTEIN. The work on that is still very much a work in progress, and so I can't answer specifically what it will include or will not include.

The basic framework that we have been talking about will, however, I think, continue to help inform the approach, meaning the two buckets that I alluded to earlier.

One bucket of issues that affect the firm's impact on the system and that includes its interconnections. It includes its size. It includes its uniqueness, if you will, or lack of substitutes.

It will include as well reference to the impact that a firm is likely to have if it fails. Those—excuse me—in addition to the impact, it will include a bucket that talks about the vulnerability of that firm.

Mr. POSEY. Okay, so you are not going to cut and paste the factors spelled out in Dodd-Frank. You are going to go into more detail. Is that correct?

Mr. GOLDSTEIN. As I said, sir, this is a work in progress and I can't speak to specifics of the final rule. That is work that is currently being undertaken, but I can assure you that the comments that have been received will be taken very seriously, and we will do our very best to be responsive to those comments.

Mr. POSEY. I assume that you are going to take the message back that the chairman and the ranking member are probably going to have you back here, and it may even get ugly next time if the picture is not clearly received.

Is that correct, Mr. Chairman?

Chairman NEUGEBAUER. Would the gentleman yield?

Mr. POSEY. Yes.

Chairman NEUGEBAUER. I think one of the things that is becoming clear in this hearing is that, and this is I think what we were talking about throughout the implementation of Dodd-Frank, is what we are hearing is that these rules are being put out with very little information, very difficult to respond to or to give comment to because they are really not sure what they are commenting to.

The other thing that we are hearing from the people is that there is no across the spectrum of analysis of what jointly all of these rules, the implications that they are going to have on competitiveness, on safety and soundness and on compliance where we have, and I think the question is going to come up here shortly, that we have some conflicting rules.

And so, I think it is absurd that we are going to issue a rule as important as this, and we do not have specifics of what criteria are

going to be used until after you have already decided that, and you are already deciding it without everybody at the table.

And so Mr. Goldstein, I hope that when you go back to the Secretary, I think the message is that I think a review of this process is in order.

And with that, I apologize and yield back.

Mr. POSEY. Yes, thank you. Just to put it one more way, I think everyone is troubled that FSOC appears to be ignoring the question of what precise criteria that it is going to use in its designations of whether a company is systemically relevant.

I think that you would have to agree that it would be a good idea for FSOC to get out to the public some kind of additional information about the rule proposal metrics.

And rather than keeping that information vague and uncertain, which is what we have heard today and which is what there was before, it should be clear what standards are going to be used to make that kind of determination and allow an opportunity for the interested persons to comment before any final version of the rule is issued.

Is there any question about what I just said? Did anybody here not understand what I said? Is it pretty clear to everybody?

Thank you very much. Thank you.

Mr. GENSLER. It is clear here, and as one member of the FSOC, I would hope that we would put the transcript of this hearing in our comment file at the FSOC because I think this is very important.

Chairman NEUGEBAUER. Absolutely. I think you can expect more than just a comment.

Mr. GENSLER. No, no. I understand that. I am listening pretty closely.

Mr. GOLDSTEIN. We fully appreciate—

Chairman NEUGEBAUER. Now, the gentleman from Minnesota, Mr. Ellison?

Mr. ELLISON. Thank you, Mr. Chairman. I appreciate you having this hearing.

Just a few questions, and my first question is this. We are in the middle of a huge budgetary debate here in Congress, have been since the beginning of the year, and certainly will be for the foreseeable future.

How does this budgetary fight impact your ability to collectively provide the financial oversight that was envisioned in Dodd-Frank? For example, if there are massive cuts to the CFTC or any one of your agencies, can you do the job that we are asking you to do?

Mr. GENSLER. No. The CFTC is a small agency, about 675 people. I think we are a very good investment for the American public. But we have just been asked, along with the SEC, to take on a market, the swaps market, that is 7 times the size of what we currently regulate.

It is interconnected to the entire real economy. It is very important to the real economy, so the real economy can lock in prices, hedge the risk in a transparent and competitive marketplace. I look forward to working with Congress on securing the necessary resources.

Mr. ELLISON. Mr. Cook?

Mr. COOK. I would just echo the comments with respect to the SEC. The amount of work that the SEC has as a result of Dodd-Frank is quite significant and extensive. There is the rule-writing phase and then there is the implementation phase, and I think we need to think about both of those in terms of the adequate resources.

We recognize the very difficult situation we are in, in terms of the budget, but I think at some point a decision will have to be made about what is doable and not doable in terms of implementing those parts of Dodd-Frank.

Mr. ELLISON. So we have charged you with financial oversight and systemic risk, but we are not going to give you the tools you need to do it, or we might not?

Let me ask my next question. In the aftermath of all of the mergers and acquisitions that we have seen over the course of the last 24 months, and you all know exactly what I am talking about, right? We have seen a more concentrated, it seems to me more systemically interconnected and perhaps vulnerable system.

Do you agree with that? If you do, have you given any thought in your work to really scale down and also increase the number of financial firms so that we are not so—we don't have so many eggs in one basket?

Mr. GOLDSTEIN. I think that is a very important point. And in fact, it is addressed in Dodd-Frank through the updating of the concentration limits. Before Dodd-Frank, concentration limits were based upon deposit market share.

In Dodd-Frank, that was updated to have a more broad view of liabilities. And one of the studies that FSOC did was to assess the impact of this concentration limit which limits any one institution to 10 percent of aggregate liabilities and cannot grow beyond that by acquisition.

That study found that in the fullness of time, that concentration limit will, in fact, make the system stronger, deeper, wider and help eliminate moral hazard and other problems. And we think that is a very important part of the legislation.

Mr. ELLISON. Anybody else on this concentration problem?

Mr. GENSLER. Yes, I would just maybe add, I do think it is a perverse outcome of a crisis, and a crisis that the system failed, that it is more highly concentrated. One of the things Congress said was that the swaps marketplace, the derivatives marketplace get the benefit of risk reduction in something called "central clearing," which helps to address some of the interconnectedness—not all of it, but some of it.

And so that is why I think it is very important that we move forward. We thoughtfully consider comment. We are not going to rush this by the date of July. We will consider the comments, but try to finalize our rules on clearinghouses and other parts of the swaps marketplace.

Mr. ELLISON. So I have a yellow light and I have one more question. The Office of Financial Research is part of what is going to help you do your job. How are you staffing that? And where are we at in terms of the appointment of a Director? Can you just give us a status update?

Mr. GOLDSTEIN. The appointment of the Director has not taken place as yet, and that is a decision by the President. But we have not let the absence of a director inhibit our continued aggressive push on the three core mandates of the Office of Financial Research, the standardization agenda.

And some important work that is taking place, by way of example, in partnership with the CFTC and the SEC on one standardization project by way of example on so-called "legal entity identifiers."

There is important work that is taking place on the second mandate, which is the development of collection and data dissemination, importantly being guided by an FSOC group on data to help ensure that work is not duplicative, but rather is coordinated across FSOC members.

And in addition to that, there is the development of an already early implementation of an important part of the research and analysis agenda of the Office of Financial Research.

Mr. ELLISON. I have a red light, so let me thank all of you for being here and wish you the best in protecting our financial system.

Chairman NEUGEBAUER. I thank the gentleman.

And we have been joined by a member of the full committee, one of the more ranking members and Mr. Royce, from California, for 5 minutes.

Mr. ROYCE. Thank you very much, Mr. Chairman.

I would like to direct my question to Mr. Goldstein. Just going over the concerns that economists had, and certainly a vigorous opposition that was put up to both the labeling of firms as systemically important, given the market distortions that would surely follow, and the resolution mechanism that could be used should they begin to fail.

Given the concerns over moral hazard and all the rest of it that we had here in the United States, let me ask you from Treasury's standpoint, this is a purely domestic resolution authority. So it is going to apply only within the United States.

Any type of cross-border resolution authority would require either agreement among the various governments involved or some form of synchronization of the relative parts of the commercial Bankruptcy Codes and procedures. This would have to be worked out to be uniform. Let me just ask you if Treasury is engaged in such conversations.

Mr. GOLDSTEIN. I think Treasury is engaged in those conversations, but I also think that other members of the panel, including the Federal Reserve Board and the FDIC, have been engaged in discussions to help ensure that the Orderly Liquidation Authority is robust, not only domestically but internationally.

But I would agree with you, sir, that work needs to be done in order to help ensure that this is an international process.

Mr. ROYCE. And I follow the conversations about the conversations, but I don't think that work is going to get done.

Simon Johnson is the former chief economist at the IMF. And as he says—and I am just going to quote him: "For more than a decade the IMF has been advising that the euro zone adopt some sort

of cross-border resolution mechanism, but European and other governments do not want to take this kind of step."

And as he says, "rightly or wrongly, they do not credibly commit to how they would handle large-scale financial failure, preferring instead to rely on various kinds of ad hoc and spontaneous measures." That is the reality of where Europe is on this.

And in closing, I understand that you are testifying today, the witnesses, to the belief that this designation and the resolution authority is going to help long term with mitigating systemic risk. I simply disagree.

I think the economists who have raised their concerns in terms of the moral hazard of doing this are correct. And beyond this fact, the greater worry I have here is that it is likely unworkable.

It will cause significant market distortions. That is readily apparent to all economists and even to many of you who might support what was done here. It is going to cause market distortions.

Increased measures to control risk such as higher capital requirements are constantly undermined anyway and avoided by the regulated entities. There is a precedent for this, and I see no reason why that isn't going to continue.

You are doing this in an environment in which you are not getting buy-in by the regulatory authorities overseas. I just don't see that happening. And being stamped too-big-to-fail is unprecedented, but on top of that, it is irreversible once you stamp an institution that way.

These firms have benefited from being caught in the government's safety net throughout the financial crisis. They are surely going to benefit now from this explicit backstop in the future. It is going to be a lower cost of capital for them.

And I would simply like to caution you to tread carefully here. The broader this line is drawn, the more institutions labeled systemically important, the larger the safety net will grow under our financial sector and the harder it will be to reverse.

And the one thing I would hope we would learn from the past is the cost of that safety net continuing to expand in this way and the moral hazard that goes with it.

Thank you, Mr. Chairman.

Chairman NEUGEBAUER. I thank the chairman.

And I now recognize the ranking member of the subcommittee.

Mr. CAPUANO. Thank you, Mr. Chairman.

Mr. Chairman, before I forget, I would like to ask unanimous consent to put a recent speech by Governor Dan Tarullo into the record.

Chairman NEUGEBAUER. Without objection, it is so ordered.

Mr. CAPUANO. Mr. Chairman, I guess everybody here except me knows what Europe is going to do. I am not even sure what America is going to do. That is what the purpose of this hearing was about, to try to figure out what you guys are doing behind those closed doors, maybe actually open up one or two of those doors.

Does anybody here know what Europe is going to do, or any portion of Europe? Does anybody here know what Asia is going to do? I don't see any hands raising, so I assume you are as much in the guessing game as we all are.

But all I can say is that what I did see Europe do when this crisis first unfolded was first go down one direction, and then in a matter of weeks, withdraw from that direction and follow the same direction the United States took. Now, whether that was right or wrong, I don't know. But that is what happened.

So I guess I do want to be clear, market distortion, that is what I want. And I want it because the market technically "undistorted" ruined or came close to ruining the world economy, which is the whole purpose of the Dodd-Frank bill, to limit the ability of 1 or 2 or 10 or 100 firms to destroy the world economy again.

Now, if you want to call that a market distortion, so be it. I don't. I call it thoughtful, intelligent regulation, which is where we hope that you will go.

But in order to get back to what I thought was the purpose of this hearing, which is to kind of figure out what you are doing as opposed to relitigating what we have already done and having those debates again, which we will have if we are forced to have. I don't find them very useful.

I do think it is important, to the best of our ability, which is why I go back to what I said in my opening statement, that I see this as a living situation. Europe will take action at some point. Asia will take action at some point. And when they do, there certainly will be a need to coordinate.

My hope, and I would like to hear it verbally, is that you are aware of that, and not necessarily will follow them or take their lead, but at least consider whatever they do, as I hope they will consider whatever we do, so that there will be a reduced as much as possible difference of opinion.

Nobody is looking to overregulate American companies and non-American companies, but at least an idea to intentionally know what we are doing. Is there anybody here who disagrees with that as we move forward?

Mr. GENSLER. I agree. It is what we are doing at the CFTC on derivatives regulation. It is what I do as a member of the FSOC.

Mr. GOLDSTEIN. I, too, fully agree with that, and we are trying both individually and collectively to be in communication with and, hopefully, advance the level playing field.

Mr. HUFF. I also agree, and on insurance, it is imperative that we remain very active internationally and domestically for systemic risk.

Ms. LIANG. I agree on all fronts.

Mr. COOK. I would echo that. And to that, I think that there are two dynamics there. One is the ongoing close dialogue with the other regulators to maintain information sharing. And the other part is as we roll out our rules, to make sure we are being very thoughtful and careful about what we are doing.

And as you say, it is not a one-shot thing. We need to think about how the framework will evolve over time and maybe approach it with a sense of what should we do first and what should we do second and what should we do third, a phasing mentality.

Mr. MURTON. We agree also. And we have been working on many fronts, particularly on cross-border resolution issues. We have been working with other jurisdictions quite a bit on that.

Mr. LONG. I agree with everything that was said.

Mr. CAPUANO. Thank you, Mr. Long. And since the yellow light is on, I want to add my voice, too, to the exhortation and suggestion that the insurance industry be more fully included in this.

The Federal Government has never regulated insurance companies. I am a proponent of an optional Federal charter for insurance companies. So I think that is the way it is going to head whether we do it tomorrow or next year or 10 years from now. It is going to get there.

So I think that the insurance industry should be heard, but I will be clear. It is not just the insurance industry. We have never regulated the hedge fund industry. We have never regulated the mutual fund industry, all of which may or may not be included.

So all of those industries that none of you have ever overseen should be heard, which is why I go back to my original point. When you have come up with these regulations, give them all an opportunity to be heard again as to specifically how that might impact industries that you have never regulated. And I wouldn't expect you to be experts in those areas—some day, but not yet.

With that, I yield back the time I don't have.

[laughter]

Chairman NEUGEBAUER. I thank the ranking member.

I want to go back to another statutory requirement in FSOC, and I will read—just paraphrase it here—facilitate coordination among member agencies regarding policy development and rulemakings. Recently, the CFTC and the SEC issued rules on Swap Execution Facilities (SEFs).

And the CFTC proposed that requests for quotes be sent to at least five SEFs. The SEC required one request for a quote. Is that the kind of coordination policy that meets the spirit of Dodd-Frank?

Mr. Cook?

Mr. COOK. Thank you, Mr. Chairman. I think when one looks at the SEF rule and at all the other rules, ultimately they have been the outcome of a lot of consultation and discussion across the two agencies. We have had some joint roundtables together. There is lots of active dialogue.

Now, there are some differences in some of the rules. And I think we only proposed them at this stage, and we need to go back and consider the comments that we have gotten.

There may be some differences that are borne out by differences in products or differences in the trading characteristics of the market. I think most would agree that those are legitimate differences and important differences to maintain.

There may be other differences in our rules that reflect a different understanding of the facts of the markets or a different understanding, a different approach to the policy.

And I think on those, as we move forward with the adoption stage, we need to be in very close coordination and make sure we understand what is the nature of those differences and try to bring them as close together as possible.

Chairman NEUGEBAUER. Here is the question, and I am going to let Mr. Gensler respond, but you are both working on the same issue. If we are to facilitate coordination of the member agencies, why, before those rules are put out, would you all not not coordinate and come up with a consistent regulation?

I think, again, this is a part of the credibility of this and so it, from my perspective, doesn't sound like that FSOC is meeting the spirit of some of the statutory duties here if we are not doing that.

We have other examples. We have the FDIC with an overdraft policy. I don't know what the OCC's policy is going to be on that, but it looks like to me there ought to be some dialogue going on so that we are all seeing it from the same book.

Because these kinds of things have implications on our financial markets. And the consequences aren't just to these entities, but are ultimately to the financial markets as a whole.

So Mr. Gensler, do you want to respond to that?

Mr. GENSLER. Yes. I think that, in fact, we have at the CFTC done just what you have said. We have had nearly 600 meetings with fellow regulators. We shared, starting last September, all of our internal drafts, term sheets and so forth on the specific rules that you are referring to, it is mostly with the SEC but the Federal Reserve has been a terrific partner, as well as the FDIC and the OCC on many of our rules.

And on the specific rule, there are some differences in the underlying statute and trading patterns in the futures markets and the securities markets. We have jurisdiction, for instance, on interest rate swaps that have different characteristics than some of the equity or credit default swaps that the SEC will have.

Again, as Mr. Cook says, it is just a proposal. But they were very aware, and we were very aware of the swap execution facility rule, we won't get much credit for it in this hearing, well over 90 percent of it is the same and very similar language and tack.

But you were right. There is this difference on requests for quotes. And we have a lot of comments on it, probably hundreds of comments on it. And we are going to take that into consideration as we go towards considering final rules this summer and fall.

Chairman NEUGEBAUER. So the question is, who is in charge of the FSOC?

Mr. GOLDSTEIN. The Secretary of the Treasury is the Chairman of the FSOC. And the FSOC has some very specific statutory oversight on rulemaking, so for example, coordination of the Volcker Rule, implementation and coordination of risk retention.

In addition, the FSOC has been a very important body for discussions of this sort for collaboration and coordination. Ultimately, the decision on something like this is the SEC and the CFTC. But I think that the FSOC can and will play an important role in being a forum to help achieve consistency, which I think all of us would share, is an important objective.

Chairman NEUGEBAUER. And I would agree with you on that. But I think what we need here is some leadership from that position, in that it is—obviously we are not necessarily accomplishing the goal here.

And I think if otherwise we sold that we were going to—that Dodd-Frank would bring some consolidation to the regulatory process and not bring additional confusion and another layer there. And if that coordination is going to be an integral part of that, and it is not happening, then we failed here.

So I think another message we want to send back is that these kinds of differences hopefully would be worked out before we get

out with these regulations rather than after where then we confuse—if market certainty is one of the roles of government and transparency and integrity, but certainty is another piece of it.

We have to bring more certainty than we are bringing, and what we have heard in this hearing today is we may be not be helping the certainty piece of it much.

With that, I go back to the gentleman from Massachusetts.

Mr. LYNCH. Thank you, Mr. Chairman. We have all, obviously, handed you an awful lot of responsibility. And much of it, as Mr. Capuano has noted, may be new areas of regulation.

I know that you are required to meet under Dodd-Frank, I think, quarterly. And I understand that at least in the formation stage, your staffs are meeting every couple of weeks. Is that right?

What about resources? I know there is a sense that the chairman has pointed out a lack of coordination, but I was just curious about resources and whether you think that the current formation, the way this is working, is sustainable.

Mr. GOLDSTEIN. I think you are correct that the principals have met more often than the quarterly mandate in the statute. Deputies meet on a biweekly basis to help set the agenda and drive—

Mr. LYNCH. I don't want to burn my question. This is a small question. So resource-wise, do you think it is adequate right now?

Mr. GOLDSTEIN. We think we have adequate resources and we benefit not only from direct hires, which we will continue to make, but we also have DTLEs from member agencies that help make sure that the FSOC staff is informed and has the expertise from across—

Mr. LYNCH. Okay. That is great. Thank you. Thank you, Mr. Goldstein.

I am also concerned about the designation of financially significant or risk-based institutions. And you have a bunch of criteria that you could apply. You have large industries, like the mutual fund industry that are incredibly large when you look at their size, but when you look at the history here, they haven't really been a part of the problem here.

And I just wonder how that balances out, because it seems like they are, frankly, they have provided the ability for a lot of working folks, a lot of middle-class folks to accumulate wealth. They haven't been a source of the erratic behavior or the danger that we have seen in the economy over this past crisis.

Yet, they are under the gun, so to speak, where they might be, because of their size, included within your scrutiny or heavier scrutiny than was previously the case. How do you balance out those factors with respect to mutual funds?

Mr. GOLDSTEIN. The statute makes very clear that there is a distinguished—there needs to be distinguished on balance sheet assets and managed assets.

Mr. LYNCH. Okay.

Mr. GOLDSTEIN. And I think that there is an awareness of that important distinction—

Mr. LYNCH. Right.

Mr. GOLDSTEIN. —as we think through the designation process.

Mr. LYNCH. They are managing other people's money. They are not investing their own, right?

Mr. GOLDSTEIN. Correct, sir.

Mr. LYNCH. Okay. And lastly, I would like to say that given the fact that we did bail out a fair number of foreign banks with U.S. resources, Fed resources, I am always hearing this threat that we are afraid we are going to lose business to Europe if we pass certain regulatory guidelines or restrictions.

And I am just—look, we could put our foot down, so to speak, and use the strength of the U.S. market to say, look, we are not going to assist in an emergency capacity or a nonemergency capacity a foreign bank, if they are engaging in reckless practices, things that are outside Dodd-Frank, outside of Basel III, those type of practices that might make them more attractive to some institutions.

But, there have to be some consequences to those banks operating in a fashion that we don't agree with. And I think that we could certainly close down the discount window to those banks and institutions that we feel are not compliant with Dodd-Frank.

And I would like to get your sense, Mr. Goldstein, on that, and anybody else who would like to jump in.

Ms. Liang?

Ms. LIANG. I think the issue of access to the discount window is an issue that the Congress could consider. There would be a number of considerations, to consider, again, international cooperation, reciprocal agreements, etc.

I think we are all in favor of trying to promote a level playing field for U.S. institutions, recognizing the potential for regulatory arbitrage, moving not just activities from the U.S. banking system or the regulated sector into foreign regulated sectors, but outside the regulated sector entirely. So I think those are all considerations we need to consider, I think.

Mr. LYNCH. All right, thank you.

Mr. Chairman, I see my time has expired. I yield back.

Chairman NEUGEBAUER. I thank the gentleman.

The gentleman from Pennsylvania, Mr. Fitzpatrick?

Mr. FITZPATRICK. Thank you, Mr. Chairman.

Our Nation is facing a spending-driven debt crisis. The national debt is now over $14 trillion. Forty-two cents of every dollar the Federal Government spends in 2011 will be borrowed.

Admiral Mike Mullen, who, of course, is Chairman of the Joint Chiefs of Staff, has identified the greatest threat to our national security, not a military threat or a terrorist threat, but our national debt.

And Erskine Bowles, who is one of the President's leaders on the National Commission on Fiscal Responsibility and Reform, has likened the national debt to a cancer. He said that it will truly destroy our Nation from within.

Given the fact that it is the job of FSOC to identify emerging threats, I would ask Mr. Goldstein, what work has FSOC done to address the debt crisis?

Mr. GOLDSTEIN. The FSOC addresses a wide variety of issues. The FSOC has not taken up this specific issue in its deliberations, but I would assure you, sir, that, as the President articulated yesterday, the important fiscal consolidation, the importance of ad-

dressing the debt load of this country, is paramount in the view of this Administration.

And I think that the $4 trillion number that was articulated in his speech yesterday and the path to greater fiscal sustainability is one that has the highest priority of this Administration, sir.

Mr. FITZPATRICK. Has the issue of the national debt ever come up in any of the deliberations of the Council? And if not, why not?

Mr. GENSLER. It has. Yes.

Mr. FITZPATRICK. I am sorry?

Mr. GENSLER. I just said it has.

Mr. FITZPATRICK. In what context was that?

Mr. GENSLER. Oh, we are asked by Congress, I don't remember the section, but to do an annual report with regard to risks in the financial system and risk in the financial markets. And I have certainly directed staff, and I know that others have, in the consultation on systemic risk and then in consultations on that report, that is included in the discussions around that report.

Mr. MURTON. I would just note that Chairman Bair feels this is an important issue. I would refer you to an op-ed piece that she put in The Washington Post on how the rising deficit is a concern for the financial system. So we do feel that this is something that is important, and as we prepare the annual report, we would want that to be considered.

Ms. LIANG. I would that add the Federal Reserve Board thinks that it is important to address structural fiscal imbalances.

However, we do not think we can know how any future crisis will manifest. And so our objective in the FSOC and in the Systemic Risk Committee is to identify a number of potential risks, of which this is one we have assessed.

Mr. FITZPATRICK. Mr. Huff, do you have the resources to address this issue in the context of the Council?

Mr. HUFF. The resources to bring insurance commissioners to the Council? Yes.

Mr. FITZPATRICK. Correct.

Mr. HUFF. State regulators are ready to help.

Mr. FITZPATRICK. Do you have permission from the Council, the other members of the Council to bring them to bear?

Mr. HUFF. No, sir.

Mr. FITZPATRICK. Are you waiting for that authority?

Mr. HUFF. Yes.

Mr. FITZPATRICK. I yield back.

Chairman NEUGEBAUER. As a follow up to that, what does it take for you to get permission?

Mr. HUFF. I will defer to Mr. Goldstein.

Chairman NEUGEBAUER. Yes, Mr. Goldstein, what does it take for Mr. Huff to be able to bring additional resources to the table?

Mr. GOLDSTEIN. I would like to be clear. The only limitation that the FSOC discusses as it relates to supporting Mr. Huff is the confidentiality of the Council's work.

He has not been, nor would we ever want to limit his capacity to utilize his office in the State of Missouri, nor have we limited, nor would we want to limit his ability to consult on this important issue.

The only constraint that we have put is that the member agencies of the FSOC have expressed concern about having too wide a group that is under the confidentiality umbrella outside of—

Chairman NEUGEBAUER. I heard that answer before. I guess the question is, if they sign confidentiality agreements, can Mr. Huff bring additional resources to the table?

Mr. GOLDSTEIN. We would be happy to work with Mr. Huff to make sure that he is appropriately staffed.

Chairman NEUGEBAUER. Yes. Is there any objection by any of the other members here?

I know, Mr. Long, you said on the, I guess the chief's Council, or whatever it is called, would you object to Mr. Huff bringing additional resources?

Mr. LONG. Here is the issue that we have. And, clearly, we fully support that they need to have positions that are authorized under Dodd-Frank, and he needs some help.

The discussion that FSOC deputies have had is that Mr. Huff and some of the other agencies or non-voting entities are going to need to draw from trade associations. And, those are non-government, non-State entities. They are trade associations.

So there is a concern, from the OCC standpoint, that if everybody needs to bring on five or six or seven non-government, trade association-related people and rotate them through, the numbers get big. And we do have some concerns about the confidentiality of discussions of documents.

So clearly, the signing of MOUs is important, and we need to get that executed. But I think everybody is of the same mind to get Mr. Huff the help he needs. But there is an issue here with a lot of people around the table.

Chairman NEUGEBAUER. Why don't we see if we can get it resolved? That would be helpful.

All right, back to the gentlewoman from New York.

Dr. HAYWORTH. Thank you, Mr. Chairman.

In listening, and thank you for your patience today and for all of the thoughtful answers that you have all provided, in listening, there is a sense that there is this regulatory world.

You kind of live on this Cartesian plane of ideals, if you will, and then, of course, there is the real world. And when we talk about deficit and debt, we need an economy that can actually support a great leap into greater prosperity.

I had the opportunity, earlier this week, to speak with some men and women who are substantially involved in the health of our financial industry. And they expressed great frustration with a fairly specific piece, a large one of Dodd-Frank, if you will, Section 716, and it is regarding derivatives trading and the regulation thereof.

And their contention is that to endeavor to layer essentially a retail regulatory structure on, at least as they frame it, a retail regulatory structure onto institutional derivatives trading will substantially limit their capacity for flexibility, for opportunity to do their job ever better, if you will, and could actually increase risk because they can't hedge as effectively.

And the sense that I also had, in fairness to all of you, and I don't doubt your dedication at all, was that they hadn't been heard. They had been trying to break through.

You are obviously all talking with each other quite a bit, not necessarily with the happiest results sometimes, but that the real world guys have had trouble breaking through into this process to say, hey, we need some action on this now.

And we were talking about arbitrage and capital earlier, regulatory arbitrage. This seems to be one example of that risk.

What can we do to facilitate a more productive interaction about that?

Mr. GENSLER. Can I just say, the financial system failed America. There are 7 million people still out of work because the system failed. And yes, the regulatory system failed, too. We have had hundreds of meetings. We post them on the Web site. But I ask, what large Wall Street firm hasn't gotten a meeting with us?

They are putting their thousands of comments in. They are getting the meetings. We are soliciting meetings with them. We are going to change the final rules. But this system has to work for America and that means the transparency, the openness, the competitiveness that the Congress intended to come in Dodd-Frank.

So I think that is what we all take from the intent of what you all passed.

Dr. HAYWORTH. I think part of—in fairness to all of you on the regulatory side, part of the distress, if you will, had to do with the fact that, during the process of promulgating Dodd-Frank, they didn't feel that they were breaking through. I realize I can't lay that at your feet. That is at the legislators' feet, if you will, in the composition of Dodd-Frank.

But, nonetheless, this is one of the examples. This is happening in real-time and real opportunity is being lost in an economy that desperately needs to be as productive as possible. There is this stasis, as we all know, going on, as people await the dropping of the next shoe, if you will.

So can we offer them something today in this hearing to reassure them?

Mr. GENSLER. I personally will attend any meeting you want in your district with any of the banks, the end users. I mean—

Dr. HAYWORTH. Okay.

Mr. GENSLER. —the input is very needed and helpful to our process. But I really raise the question of anybody that hasn't been able to break through. This CFTC process, I am very proud, is pretty darn open.

Mr. GOLDSTEIN. We all have transparency policies, and I think what will be revealed is the range and depth of conversations that have been had across multiple stakeholders.

And so I would say that I think there is more than ample opportunity for people to be heard. And if you have any suggestions as to who would like to be heard who has not had an opportunity, I for one would be more than happy to be responsive to that.

Dr. HAYWORTH. I appreciate that. And perhaps we can arrange a meeting. I think that might be very productive and helpful.

Mr. GENSLER. I look forward to it.

Dr. HAYWORTH. Great. Thank you.

And I yield back, Mr. Chairman. Thank you.

Chairman NEUGEBAUER. I thank the gentlewoman. Before we conclude here, does the ranking member have any closing things?

Mr. CAPUANO. Good job.

Chairman NEUGEBAUER. I want to thank all of you for being here. It has been a very healthy discussion.

I do want to mention one thing. Mr. Goldstein, on March the 15th, Chairman Bachus and I sent a letter to your boss and asked you for information used for the application and comments submitted on the financial stability, the FSOC, regarding the study that was prepared under the Volcker Rule. We would like to—and we haven't received a response on that, so in your little tickler file, if you would, maybe?

I think what we have had is a very healthy discussion here today. The purpose of the Oversight and Investigations Subcommittee is to oversee the implementation of regulation.

And, one of the things that I think we said from the very beginning of this hearing is this is a very important piece of Dodd-Frank. It is how it is implemented and, more importantly, how it is carried is extremely important.

So I would say that this probably is not the last hearing that we are going to have on this. And when you hear Mr. Frank and others say that more transparency is important, the ranking member is saying it.

This is not a partisan issue. I think we are looking for some leadership from the Secretary in this area on the transparency. And I think the coordination is an extremely important piece of that and particularly in this rulemaking is actually having substantial things to comment on, like, what are the rules going to be?

I think, when you talk to me about rulemaking, you say, well, what do you think about the rule? And we already had an opportunity to speak on what we thought about the legislation. What we want to have is an opportunity now to speak about the interpretation of that legislation, which is a rule and certainly has to be more specific than just regurgitating what is in the legislation.

So I hope that the next time you have a little team meeting, you will say, did you hear what I heard when we went before Congress?

And with that, I remind members that the record will remain open for 30 days for members to submit additional questions to the witnesses and to place their responses in the record.

We are adjourned.

[Whereupon, at 12:35 p.m., the hearing was adjourned.]

A P P E N D I X

April 14, 2011

Opening Statement
Chairman Randy Neugebauer
Oversight & Investigations Subcommittee

"Oversight of the Financial Stability Oversight Council"
April 14, 2011

Proponents and opponents of the Dodd-Frank Act can all agree that its passage was a transformative event for the financial markets of the United States. The centerpiece of the Dodd-Frank Act was the creation of the Financial Stability Oversight Council, which is tasked with identifying emerging threats to the financial stability of the United States and coordinating regulatory actions to address them.

Given its recent creation and the immensity of its mandate we are having this important hearing to get a better understanding of FSOC's roles and responsibilities, the impacts of its decisions on the global competitiveness of our capital market, and whether there is sufficient leadership by the Chairman of the Council to carry out its broad mandate.

While I am fully aware that the Council is still in its organizational phase, there are already emerging trouble areas that merit attention by this Subcommittee and the United State Congress. I am deeply concerned that if the problems identified in this hearing are not addressed early on, this entity could have a severe negative impact on the functionality and competitiveness of our businesses and markets.

The Council publicly states on its website that it is "committed to conducting its business in an open and transparent manner." Yet, documents reviewed by my staff clearly demonstrate that the Council has kept hidden from public view the criteria for formulating "systemically important" designations. Given the potential impact of these standards on the general economy, it is imperative the Council maintain its promise to operate in a transparent manner and allow the public to provide meaningful comments on the true criteria for SIFI designations.

The Council has a statutory duty to facilitate coordination among member agencies regarding policy development and rulemaking. The importance of this coordinating role is underscored by the Dodd-Frank Act's extensive interagency rulemaking requirements. Yet, since the enactment of Dodd-Frank, there appears to be serious deficiencies in rulemaking coordination –most notably between the CFTC and SEC. Without strong leadership from the Chairman of the Council, regulatory overlap and duplication may add another layer of compliance costs that will undoubtedly harm the growth of the U.S. economy.

The Council is also required to monitor international financial regulatory developments and "advise Congress and make recommendations in these areas that will enhance the competitiveness of the U.S. financial markets." Yet, FSOC's initial

recommendations under the Dodd-Frank Act - the Volcker Rule and Concentration Limits - place U.S. firms at a competitive disadvantage to its global counterparts.

And finally, FSOC's rule to designate certain nonbank financial firms as "systemically important" is proceeding without any representative at the federal level who truly understands the business of insurance. On top of that, Director John Huff, who is the only insurance expert (non-voting) currently participating on the Council has publicly declared his frustration with his ability to "meaningfully participate" and "provide the regulatory perspective of the insurance sector in these critical discussions." Mr. Huff has even offered additional NAIC staff to support the work of FSOC at no additional cost to the U.S. taxpayers. Unfortunately, his complaints and generous offer have been ignored by the Chairman of the Council.

I look forward to hearing from our witnesses today and I hope that through this hearing we send an important message regarding the need for strong leadership by the Chairman of the Financial Stability Oversight Council.

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Testimony on the Financial Stability Oversight Council

Robert Cook, Director, Division of Trading and Markets
on behalf of Mary L. Schapiro, Chairman
U.S. Securities and Exchange Commission

Before the
United States House of Representatives Committee on Financial Services
Subcommittee on Oversight and Investigations

Thursday, April 14, 2011

Thank you for the opportunity to testify on behalf of the Chairman of the Securities and Exchange Commission[1] regarding the Financial Stability Oversight Council ("FSOC" or the "Council"). FSOC was created by Title I of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") and has 10 voting members: the senior officials at each of the nine federal financial regulators[2] and an independent member with insurance expertise appointed by the President. FSOC's composition also includes five nonvoting advisory members: three from various state financial regulators[3] as well as the Directors of the new Federal Insurance Office and Office of Financial Research ("OFR").[4]

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[1] The views expressed in this testimony are those of the Chairman of the Securities and Exchange Commission, a member of FSOC, and do not necessarily represent the views of the full Commission.

[2] The senior officials are the Secretary of the Treasury (Chairperson); Chairman of the Board of Governors of the Federal Reserve; Comptroller of the Currency; Director of the Consumer Financial Protection Bureau; Chairman of the Securities and Exchange Commission; Chairperson of the Federal Deposit Insurance Corporation; Chairperson of the Commodities Futures Trading Commission; Director of the Federal Housing Finance Agency; and Chairman of the National Credit Union Administration. *See* Dodd-Frank Act § 111(b)(1).

[3] The state financial regulators are a state insurance commissioner designated by the state insurance commissioners; a state banking supervisor designated by the state banking regulators; and a state securities commissioner designated by the state securities commissioners. *See* Dodd-Frank Act § 111(b)(2).

[4] *See* Dodd-Frank Act § 111(b)(2).

Under the Dodd-Frank Act, Congress has given FSOC the following primary responsibilities:

- identifying risks to the financial stability of the United States that could arise from the material financial distress or failure – or ongoing activities – of large, interconnected bank holding companies or nonbank financial holding companies, or that could arise outside the financial services marketplace;
- promoting market discipline by eliminating expectations on the part of shareholders, creditors, and counterparties of such companies that the government will shield them from losses in the event of failure (*i.e.*, addressing the moral hazard problem of "too big to fail"); and
- identifying and responding to emerging threats to the stability of the United States financial system.[5]

In fulfilling its responsibilities, FSOC is charged with identifying and designating certain nonbank financial companies as systemically important financial institutions ("SIFIs") for heightened prudential supervision by the Board of Governors of the Federal Reserve System ("Federal Reserve Board").[6] In addition, FSOC may make recommendations to the Federal Reserve Board concerning the establishment and refinement of heightened prudential standards for firms designated under the SIFI process and large, interconnected bank holding companies already supervised by the Federal Reserve Board.[7] Such recommendations may address, among other things, risk-based capital, leverage, liquidity, contingent capital, resolution plans and credit

[5] *See* Dodd-Frank Act § 112(a)(1).

[6] *See* Dodd-Frank Act §§ 112(a)(2)(H) and 113.

[7] *See* Dodd-Frank Act § 112(a)(2)(I).

exposure reports, concentration limits, enhanced public disclosures and overall risk management.[8] In addition, FSOC must identify and designate financial market utilities ("FMUs") and payment, clearing, and settlement activities that are, or are likely to become, systemically important.[9]

The recent financial crisis demonstrated the potential for risks to quickly spread across the financial sector and undermine general confidence in the financial system. To address issues of "siloed" information and the potential for regulatory arbitrage, another key responsibility of FSOC is to monitor the financial markets and regulatory framework to identify gaps, weaknesses and risks and make recommendations to address those issues to its member agencies and to Congress.[10] In addition, by combining the information resources of its member agencies and working with the OFR, FSOC is responsible for facilitating the collection and sharing of information about risks across the financial system.[11]

FSOC Activities Update

Since passage of the Dodd-Frank Act, FSOC has taken steps to create an organizational structure, coordinate interagency efforts, and build the foundation for meeting its statutory responsibilities. In the weeks leading up to the inaugural October 1, 2010 meeting of the principals of the FSOC agencies, staff from the Treasury Department coordinated interagency staff work to establish by-laws and develop a transparency policy. During that period, FSOC also formed several interagency committees to address specific statutory requirements.

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[8] *See id.*

[9] *See* Dodd-Frank Act §§ 112(a)(2)(J) and 804(a).

[10] *See* Dodd-Frank Act § 112(a)(2)(C)-(G).

[11] *See* Dodd-Frank Act § 112(a)(2)(A)-(B).

Designation of Systemically Important Financial Institutions

To begin defining and implementing the process to identify and designate SIFIs for heightened supervision by the Federal Reserve Board, FSOC established a SIFI designations committee and several staff subcommittees to tackle specific tasks.

On October 6, 2010, FSOC issued an advanced notice of proposed rulemaking soliciting public comment on the specific criteria and analytical framework for the SIFI designation process, with a focus on how to apply the statutory considerations for such designations. FSOC received over 50 comment letters from trade associations, financial firms, individuals, and others. These comment letters included views on the designation process itself, as well as suggestions on the specific criteria and metrics to be used and the frameworks for their application.

On January 26, 2011, FSOC issued a notice of proposed rulemaking regarding the SIFI designation process. The proposed rule describes the criteria that will inform – and the processes and procedures established under the Dodd-Frank Act for – designations by FSOC. Such criteria would be rooted in the eleven (11) statutory considerations set forth in the Dodd-Frank Act for such designations, and would include, among other considerations, a firm's size, leverage, liquidity risk, maturity mismatch, and interconnectedness with other financial firms. The proposed rule also implements certain other provisions of the designation process, including: (1) the anti-evasion authority of FSOC; (2) procedures for notice of, and the opportunity for a hearing on, a proposed determination; and (3) procedures regarding consultation, coordination, and judicial review in connection with a determination.

Designation of Systemically Important Financial Market Utilities

FMUs are essential to the proper functioning of the nation's financial markets.[12] These utilities form critical links among marketplaces and intermediaries that can strengthen the financial system by reducing counterparty credit risk among market participants, creating significant efficiencies in trading activities, and promoting transparency in financial markets. However, FMUs by their nature create and concentrate new risks that could affect the stability of the broader financial system. To address these risks, Title VIII of the Dodd-Frank Act provides important new enhancements to the regulation and supervision of FMUs designated as systemically important by FSOC ("DFMUs") and of payment, clearance and settlement activities. This enhanced authority in Title VIII should provide consistency, promote robust risk management and safety and soundness, reduce systemic risks, and support the stability of the broader financial system.[13] Importantly, the enhanced authority in Title VIII is designed to be in addition to the authority and requirements of the Securities Exchange Act and Commodity Exchange Act that may apply to FMUs and financial institutions that conduct designated activities.[14]

FSOC established an interagency DFMU committee to develop a framework for the designation of systemically important FMUs, in which staff from the SEC has actively participated. On December 21, 2010, FSOC published an advanced notice of proposed rulemaking seeking public comment on the designation process for FMUs. In response, FSOC received 12 comment letters from industry groups, advocacy and public interest groups,

[12] Section 803(6) of the Dodd-Frank Act defines a financial market utility as "any person that manages or operates a multilateral system for the purpose of transferring, clearing, or settling payments, securities, or other financial transactions among financial institutions or between financial institutions and the person."

[13] *See* Dodd-Frank Act § 802.

[14] *See* Dodd-Frank Act § 805.

individual FMUs and financial institutions. Among other things, commenters generally encouraged the development of metrics and an analytical framework to further define the statutory considerations for designation contained in Title VIII, and also emphasized the need for FSOC to apply consistent standards for all FMUs under consideration for designation that incorporate both qualitative and quantitative factors.

On March 28, 2011, FSOC published a notice of proposed rulemaking to provide further information on the process it proposed to follow when reviewing the systemic importance of FMUs. FSOC is considering using a two-stage process for evaluating FMUs prior to a vote on a proposed designation by the Council. The first stage would consist of a largely data-driven process to identify a preliminary set of FMUs whose failure or disruption could potentially threaten the stability of the U.S. financial system. In the second stage, FMUs so identified would be subject to a more in-depth review, with a greater focus on qualitative factors and FMU- and market-specific considerations. Under the proposal, the Council expects to use the statutory considerations as a base for assessing the systemic importance of FMUs.[15] Application of this framework, however, would be adapted for the risks presented by a particular type of FMU and business model.

Systemic Risk Assessment

In addition to initiating work on the identification of SIFIs and DFMUs, FSOC has established a Systemic Risk Committee that seeks to identify, highlight and review possible risks

[15] Section 804(a)(2) of the Dodd Frank Act provides that these considerations are: (1) the aggregate monetary value of transactions processed by the FMU or carried out through the PCS activity; (2) the aggregate exposure of the FMU or a financial institution engaged in PCS activities to its counterparties; (3) the relationship, interdependencies, or other interactions of the FMU or PCS activity with other FMUs or PCS activities; (4) the effect that the failure of or a disruption to the FMU or PCS activity would have on critical markets, financial institutions, or the broader financial system; and (5) any other factors that FSOC deems appropriate.

that could develop across the financial system. The Dodd-Frank Act also requires FSOC to report annually to Congress regarding these risks,[16] and we expect the work of this committee will inform that report.

Other Activities

In addition to seeking to identify possible risks in the financial system, FSOC was required under Section 619(b) of the Dodd Frank Act to study and make recommendations on implementing the Act's restrictions on proprietary trading, commonly referred to as the "Volcker rule," to achieve certain goals enumerated in the statute, including:

- to promote and enhance the safety and soundness of banking entities;
- protect taxpayers and consumers; and
- enhance financial stability by minimizing the risk that insured depository institutions and their affiliates will engage in unsafe and unsound activities.

On October 6, 2010, FSOC published a notice and request for information. In response, it received more than 8,000 comment letters, including approximately 1,450 letters that set forth individual perspectives from market participants, Congress, and the public.

On January 18, 2011, FSOC released its study and recommendations on implementation of the Volcker rule. The study recommends the creation of rules and a supervisory framework that effectively prohibit proprietary trading activities throughout "banking entities" – as defined by the Dodd-Frank Act – and appropriately distinguish prohibited proprietary trading from statutorily described permitted activities. The recommended supervisory framework consists of a programmatic compliance regime, metrics, supervisory review and oversight, and enforcement

[16] *See* Dodd-Frank Act § 112(a)(2)(N).

procedures for violations for the respective regulatory agencies conducting supervisory review and oversight. In addition, the study identified potential challenges in delineating prohibited proprietary trading activities from permitted activities, including potential difficulties in determining whether a position was taken in anticipation of near term customer demand or for speculative purposes.

The study also recognizes that effective oversight by the agencies will require specialized skills and be resource intensive. For example, the study notes agencies will need additional resources to develop appropriate data points, build infrastructure to obtain and review information, and hire and train additional staff with quantitative and market expertise to identify and investigate outliers and questionable trading activity.

Next Steps

While FSOC has made substantial progress in taking up its new responsibilities, its efforts are ongoing, and much remains to be done. Some of the most challenging issues regarding the potential designation of systemically important financial institutions and FMUs lie ahead, and public input both generally on this process – and specifically with respect to the notices of proposed rulemaking – will be critically important. In addition, as Dodd-Frank implementation proceeds, the coordination of the FSOC agencies will continue to be a vital consideration. We look forward to continuing to work closely with Congress as implementation continues, and I am happy to answer any questions you may have.

TESTIMONY OF GARY GENSLER

CHAIRMAN, COMMODITY FUTURES TRADING COMMISSION

BEFORE THE

U.S. HOUSE OF REPRESENTATIVES COMMITTEE ON FINANCIAL SERVICES

SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS

WASHINGTON, DC

April 14, 2011

Good afternoon Chairman Neugebauer, Ranking Member Capuano and members of the Subcommittee. I thank you for inviting me to today's hearing on the Financial Services Oversight Council (FSOC). I am pleased to testify alongside my fellow regulators.

Before I begin, I'd like to thank the hardworking staff of the CFTC for their continued efforts to implement the Dodd-Frank Wall Street Reform and Consumer Protection Act and to support the mission of the FSOC.

The Financial Stability Oversight Council

In 2008, the financial system failed, and the regulatory system failed. As a result, a lot of Americans are still suffering. The crisis left them with an uncertain future. Many now own homes that are worth less than their mortgages. Many are still seeking employment.

As one response to that crisis, the Dodd-Frank Act established the FSOC to ensure protections for the American public. The Council is an opportunity for regulators – now and in the future – to ensure that the financial system works better for all Americans. The financial system should be a place where investors and savers can get a return on their money. It should provide transparent and efficient markets where borrowers and people with good ideas and business plans can raise needed capital.

The financial system also should allow people who want to hedge their risk to do so without concentrating risk in the hands of only a few financial firms. One of the challenges for the Council and for the American public is that like so many other industries, the financial industry has gotten very concentrated around a small number of very large firms. As it is unlikely that we could ever ensure that no financial institution will fail – because surely, some will in the future – we must do our utmost to ensure that when those challenges arise, the taxpayers are not forced to stand behind those institutions and that these institutions are free to fail.

There are important decisions that the Council will make, such as determinations about systemically important nonbank financial companies and systemically important financial market utilities and clearinghouses, resolving disputes between agencies and completing important studies as dictated by the Dodd-Frank Act. Though these specific decisions are important, to me it is essential that the Council make sure that the American public doesn't bear the risk of the financial system and that the system works for the American public, for investors, for small businesses, for retirees and for homeowners.

The Council's eight current voting members have coordinated closely. Treasury's leadership has been invaluable. To support the FSOC, the CFTC is providing both data and expertise relating to a variety of systemic risks, how those risks can spread through the financial system and the economy and potential ways to mitigate those risks. We also have had the opportunity to coordinate with Treasury and the Council on each of the studies and proposed rules issued by the FSOC.

I will spend my time this morning discussing a number of matters that have been on the FSOC's agenda. In particular, I will focus on the FSOC's work thus far on its authority to designate financial market utilities, including clearinghouses, as systemically important and on the Volcker Rule, as the CFTC has additional responsibilities in those areas. I also will touch on the FSOC's concentration limits study and supervision of certain nonbank financial companies.

Clearinghouses

Comprehensive and robust regulatory oversight of clearinghouses is essential to our country's financial stability. This is particularly important since, under the Dodd-Frank Act, standardized swaps between financial entities must be brought to clearinghouses.

The CFTC has overseen clearinghouses for decades. Title VII of the Dodd-Frank Act provides for enhanced oversight of these clearinghouses. In close consultation with our fellow domestic and international regulators, and particularly with the Federal Reserve and the SEC, the

CFTC proposed rulemakings on risk management for clearinghouses. These rulemakings take account of relevant international standards, particularly those developed by the Committee on Payment and Settlement Systems and the International Organization of Securities Commissions.

Title VIII of the Dodd-Frank Act gives the FSOC important roles in clearinghouse oversight by authorizing the Council to designate certain clearinghouses as systemically important. Title VIII also permits the Federal Reserve to join in the examination of such clearinghouses and to recommend heightened prudential standards in certain circumstances.

The FSOC's notice of proposed rulemaking on designating systemically important financial market utilities complements the CFTC's rulemaking efforts. Public input will be valuable in determining how the Council should apply statutory criteria to determine which clearinghouses qualify for designation as systemically important.

Volcker Rule Study

Section 619 of the Dodd-Frank Act provides that, other than certain permitted activities, "a banking entity shall not engage in proprietary trading, including trading in futures, options on futures and swaps." The CFTC is directed to adopt rules to carry out this requirement with respect to any entity "for which the CFTC is the primary financial regulatory agency."

As part of the Volcker rule's coordinated rulemaking requirement, CFTC staff has been meeting at least twice a week with other agencies, including the FDIC, Federal Reserve, Office

of the Comptroller of the Currency, SEC and Treasury Department. The goal of these meetings is to ensure, to the extent possible, that our rules on section 619 are comparable and provide for consistent application.

The FSOC's Study & Recommendations on Prohibitions on Proprietary Trading & Certain Relationships with Hedge Funds & Private Equity Funds, also known as the Volcker Rule study, provides thoughtful recommendations to carry out Congress's intent to separate proprietary trading from otherwise permitted activities of banking entities. The study also provides a basis upon which each of our agencies can move forward with the required rule-writing to carry out Congress's mandate.

In particular, the study covers financial instruments both in the cash market and in the derivatives and swaps markets. This is significant, as any risk that a banking entity could take on in the cash markets also could be expressed through swaps and derivatives. The inclusion of both prevents regulatory arbitrage. In addition, the study indicates that the books of banking entities, including swap dealers, would not be precluded from the definition of a trading account regardless of whether those accounts held illiquid financial instruments, such as swaps, and regardless of whether those positions are short-term or long-term.

Supervision of Certain Nonbank Financial Companies and Concentration Limits

Title I of the Dodd-Frank Act authorizes the FSOC to determine whether certain activities of nonbank financial companies could pose a threat to the financial stability of the

United States. Those companies would be supervised by the Federal Reserve and subject to specific prudential standards. The FSOC's proposed rulemaking on Authority to Require Supervision of Certain Nonbank Financial Companies lays out a set of designation criteria that the Council would use to determine whether nonbank financial companies are systemically significant. Effective regulation of systemically important nonbank financial entities is essential to preventing the next AIG from threatening the financial system. I look forward to seeing the staff's summary of the comments received in response to the Council's proposed rulemaking and considering the public's recommendations before moving forward to any final rulemaking in this area.

The Dodd-Frank Act also includes a provision that no financial company be permitted to grow through either merger or acquisition if the resulting companies' consolidated liabilities would exceed 10 percent of all the aggregate consolidated liabilities of all financial companies. The FSOC's Study & Recommendations Regarding Concentration Limits on Large Financial Companies is an important step in implementing Congress's direction. These limits are designed to promote financial stability by preventing the liabilities of the financial sector from becoming too concentrated in any given financial entity. The 2008 financial crisis demonstrated the potential repercussions to the American public of concentration within our financial sector.

Annual FSOC Report to Congress

Under section 112 of the Dodd-Frank Act, the FSOC is to report annually to Congress. Staff of the CFTC, including people from our Chief Economist's office, Division of Market

Oversight, and Division of Clearing and Intermediary Oversight, have been contributing to that effort. I believe this annual report can serve as an important means for the Council to communicate to Congress on the stability of the financial system and make recommendations to enhance the U.S. financial markets and protect the public.

Coordination with FSOC Member Agencies

The CFTC is consulting heavily with the member agencies of the FSOC to implement the Dodd-Frank Act. We are working very closely with the SEC, Federal Reserve, FDIC, OCC and other prudential regulators, which includes sharing many of our memos, term sheets and draft work product. We also are working closely with the Treasury Department and the new Office of Financial Research. As of Friday, CFTC staff has had 598 meetings with other regulators on implementation of the Act. This close coordination has benefited the rulemaking process and will strengthen the markets. The CFTC will consider final rules only after we have the opportunity to consult with our fellow regulators.

Conclusion

Thank you for the opportunity to testify. I'd be happy to take questions.

Embargoed Until Delivery

Testimony of Jeffrey A. Goldstein
House Financial Services Committee
Subcommittee on Oversight and Investigations
Thursday, April 14, 2011

Mr. Chairman, Ranking Member Capuano, and members of the Subcommittee, thank you for inviting me to testify today.

In July 2010, Congress passed, and the President signed into law, the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). A central piece of this legislation was the creation of the Financial Stability Oversight Council (the "Council"), which corrected a core deficiency in our country's financial regulatory structure by making a single organization accountable for monitoring and addressing risks to financial stability.

After passage of the Dodd-Frank Act, Secretary Geithner asked me to act as his deputy on the Council. In that capacity, I chair the Council's Deputies Committee as well as its Systemic Risk Committee and am working with my Council colleagues to build and execute the mandate of this new organization.

The Council's statutory mandate is to identify risks to financial stability, respond to any emerging threats in the system, and promote market discipline. The Council also has specific responsibilities to implement several key features of the Dodd-Frank Act. In particular, the Council has the authority to designate nonbank financial companies for consolidated supervision by the Board of Governors of the Federal Reserve System, and to designate financial market utilities for heightened standards. It also is required to report annually to Congress on risks to financial stability and to conduct several key studies, including studies on implementation of the Dodd-Frank Act's Volcker Rule and the Dodd-Frank Act's limits on the concentration of large financial companies. As Chair of the Council, the Secretary of the Treasury has additional statutory responsibilities, including coordination of rulemakings on credit risk retention and the Volcker Rule.

These responsibilities are substantial, but the Council has made significant progress in the short time since the Dodd-Frank Act was signed into law. Since enactment, the Council has: (1) built its basic organizational framework; (2) laid the groundwork for the designation of nonbank financial companies and financial market utilities; (3) initiated monitoring for potential risks to U.S. financial stability; (4) carried out the explicit statutory requirements of the Council, including the completion of several studies; and (5) served as a forum for discussion and coordination among the agencies implementing Dodd-Frank.

Council structure and operations

We have built a structure for the Council that is designed to promote accountability and action. Every two weeks, a Deputies Committee comprised of senior officials from each of the member agencies meets to set the Council's agenda, and to direct the work of the Council's Systemic Risk Committee and five functional committees. The functional committees are organized around the Council's ongoing statutory responsibilities: designations of nonbank financial

companies, designations of financial market utilities, heightened prudential standards, orderly liquidation and resolution plans, and data.

The Council's principals have met four times in the organization's first eight months, significantly more often than the statutorily required quarterly meetings. This pace has been driven by the substantive agenda outlined in the Dodd-Frank Act, and by the consideration of emerging issues affecting the financial system and the economy.

In addition to establishing an institutional framework, including adopting rules of operation and a budget, the first eight months of the Council's work has focused on completing statutorily required studies and beginning a transparent, rules-based process for designations of nonbank financial companies and financial market utilities.

At each meeting to date, the Council has held a public session. This exemplifies a commitment to conduct its work in as open and transparent a manner as practicable given the confidential supervisory and sensitive information that is at the heart of the Council's work. The Council also has released proposed rules to implement its Freedom of Information Act regulations, which represent a straightforward approach to implementing the requirements of the law.

Designations

Two of the Council's most important tools are its ability to designate nonbank financial companies for consolidated supervision and financial market utilities for heightened standards. The Council is engaging in two parallel rulemakings to establish a process and define criteria for these designations that are robust and transparent.

For the first time, Dodd-Frank calls for consolidated supervision of and heightened prudential standards for the largest, most interconnected nonbank financial companies. Prior to the crisis, a large financial firm could escape consolidated supervision based on its corporate form. Through the designation authority, the Council will help ensure that large, interconnected financial companies, whose material financial distress could pose a threat to U.S. financial stability, will not be permitted to avoid adequate supervision and prudential standards.

The Council also has the ongoing authority to designate financial market utilities for heightened standards. Financial market utilities are a critical part of the nation's financial infrastructure, facilitating clearing, settlements, and payments for domestic and foreign financial institutions. These elements of the financial infrastructure are highly interconnected and thus, if an important market utility fails to perform as expected or fails to manage risk appropriately, it could pose significant risk to the financial system as a whole. The Council's work will help ensure these entities do not jeopardize the broader financial system.

While the statute carefully outlines the considerations and process requirements for making these designations, the Council is conducting rulemakings to ensure transparency and to obtain input from all interested parties.

For its nonbank designations work, the Council issued an Advanced Notice of Proposed Rule or "ANPR" in October 2010 and a Notice of Proposed Rulemaking or "NPRM" in January 2011

providing guidance on the statutorily mandated criteria and defining the procedures that the Council will follow in considering the designation of nonbank financial companies. For designations of financial market utilities, public comments from last November's ANPR informed an NPRM released in March. The comment period for that NPRM is 60 days and remains open. The Council's member agencies continue to work in close collaboration, having received significant input from market participants, non-profits, academics, and members of the public to develop an analytical framework for designations that will provide a consistent approach and will incorporate the need for both quantitative and qualitative judgments.

The Council's commitment to a robust designations process goes beyond transparency during the rulemaking process. Every designation decision will be firm-specific and is subject to judicial review. Moreover, even before the Council votes on a proposed designation, a company under consideration will have the opportunity to submit written materials to the Council on whether, in the company's view, it meets the standard for designation. Only after Council members have reviewed that information will they vote on a proposed designation, which requires the support of two-thirds of the Council (including the affirmative vote of the Chair) and, if challenged, is subject to review through a formal hearing process and a two-thirds final vote. Upon the final vote, the Council must then submit a report to Congress detailing its final decision.

The Dodd-Frank Act requires Council members to evaluate a statutorily mandated set of qualitative and quantitative factors when designating a nonbank firm or a financial market utility. Since a firm's comprehensive risk profile is the result of a combination of these factors, the Council must exercise judgment during the process. Congress recognized that financial markets are dynamic and that this designations process must take into account changes in firms, markets, and risks. That is one of the key reasons that the statute mandates an annual reevaluation of any designation made by the Council.

Monitoring Threats to Financial Stability

The Council established a Systemic Risk Committee to be accountable for identifying, analyzing, and monitoring risks to financial stability and for providing regular assessments of risks to deputies and principals.

The Council has focused on significant market developments that could affect the financial system both domestically and internationally. For example, as part of its ongoing efforts, the Council and its members monitor emerging issues such as the state of mortgage foreclosures in the United States, sovereign debt developments in Europe, and the recent earthquake and tsunami tragedy in Japan. The Council also has reviewed structural issues within the financial system, such as options for reform of the money market mutual fund industry. We will continue to monitor potential threats to stability, whether from external shocks or structural areas of concern.

The Dodd-Frank Act calls for a public report to Congress each year describing the activities of the Council and the health of the financial system. Staff at each of the member agencies are already hard at work drafting the Council's first annual report. As stated in the statute, this report will: outline the activities of the Council, including any designations or recommendations made with respect to activities that could threaten financial stability; detail significant financial

market and regulatory developments; and identify potential emerging threats to the financial stability of the United States. The Council also will consider recommendations to enhance the integrity, efficiency, competitiveness, and stability of United States financial markets; promote market discipline; and maintain investor confidence.

Studies

On January 18, the Council released a study and recommendations on the implementation of the Dodd-Frank Act's "Volcker Rule". The Volcker Rule will strengthen the financial system and constrain risk by prohibiting proprietary trading and limiting relationships with hedge funds and private equity funds for banking entities that benefit directly from the government's safety net. The Council sought input from the public in advance of the study and received more than 8,000 comments. The study recommends principles for implementing the Volcker Rule and suggests a comprehensive framework for identifying activities prohibited by the Rule. That framework includes an internal compliance regime, quantitative analysis and reporting, and supervisory review.

As requested, the Council also conducted a study of the effects of the Dodd-Frank Act's limits on the concentration of large companies on financial stability. The Council's study found that the concentration limit will reduce moral hazard, increase financial stability, and improve efficiency and competition within the U.S. financial system. The study also made largely technical recommendations to mitigate practical difficulties likely to arise in the administration and enforcement of the concentration limit, without undermining its effectiveness in limiting excessive concentration among financial companies. The Council approved the study at its January meeting and released the recommendations for public comment. The Council received six comments and is currently reviewing those comments to determine whether any of the recommendations should be modified.

The Council continues to have specific responsibilities to study key issues outlined in Dodd-Frank. For instance, the Council must complete a study regarding "haircuts" to secured creditors by July and a study regarding contingent capital instruments by July 2012.

Interagency Regulatory Coordination

The Council also has served as a forum for discussion and coordination among the agencies implementing the Dodd-Frank Act.

For the Council's first meeting in October 2010, the staff of member agencies developed a detailed, public road map for implementation of the legislation. This integrated roadmap outlined a coordinated timeline of goals, both for the Council and its independent member agencies, to fully implement the Dodd-Frank Act.

As Chair of the Council, the Treasury Secretary is required to coordinate several major rulemakings under the Dodd-Frank Act. For example, to facilitate the joint rulemaking on credit risk retention, Treasury staff held frequent interagency discussions beginning shortly after the Dodd-Frank Act was passed to develop the rule text and preamble. This joint rulemaking

required reaching consensus among six rulemaking agencies. The proposed rule, released on March 31, demonstrates our ability to promote effective collaboration, and it is a significant step towards strengthening securitization markets. Treasury staff is currently engaged in a similar process with the staff of member agencies tasked with drafting the Volcker Rule.

The Council's regulatory coordination role is greater than the specific statutory instances where coordination is required. Deputies meetings have served as a forum for sharing information about significant regulatory developments, particularly those that impact the work of more than one member agency and relate to financial stability. For example, the Federal Reserve recently briefed deputies on the results of its Comprehensive Capital Analysis and Review. Treasury has provided updates on housing finance reform.

Conclusion

The work of the Council is critical to building a more effective financial regulatory system and to creating accountability over the long-term for the health of the financial system as a whole. I look forward to continuing to share our progress with you over the coming months and years.

Testimony of the
National Association of Insurance Commissioners

Before the
Subcommittee on Oversight & Investigations
Committee on Financial Services
United States House of Representatives

Regarding:
"Oversight of the Financial Stability Oversight Council"

Thursday, April 14, 2011

John M. Huff
Director, State of Missouri
Department of Insurance,
Financial Institutions and Professional Registration
On Behalf of the National Association of Insurance Commissioners

Introduction

Chairman Neugebauer, Ranking Member Capuano, and Members of the Subcommittee, thank you for the opportunity to testify today. My name is John Huff, and I am Director of the Department of Insurance, Financial Institutions and Professional Registration for the State of Missouri. I serve as a non-voting member of the Financial Stability Oversight Council (FSOC). I am also a member of the National Association of Insurance Commissioners (NAIC), and I am testifying on behalf of that organization today. Specifically, I am here to discuss the experiences of our nation's 56 insurance regulators in working, through the NAIC, with FSOC. I would also like to address the unnecessary limitations that have been placed on my ability as an FSOC member to use insurance regulatory resources and consult with my fellow regulators

As you are well aware, Title I, Subtitle A of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 establishes the FSOC, a panel of 15 members (10 voting and five non-voting) who meet regularly in order to develop the system by which financial institutions are designated Systemically Important Financial Institutions (SIFIs)—narrow, but very important, authority. By statute, there are supposed to be three representatives of insurance on the Council: a voting member with insurance expertise; the non-voting director of the Federal Insurance Office (FIO); and a non-voting state insurance commissioner, to be designated through a selection process determined by the state insurance commissioners. I have been filling that final spot since my appointment through the NAIC on September 23 of last year.

There are three matters that I wish to address in my testimony today:

- *First*, insurance is a unique product, fundamentally different from banking and securities products. Its system of state-based regulation is well-suited to the needs of consumers and companies alike. FSOC must recognize and acknowledge these differences in fulfilling its mission to monitor systemic risk within the U.S. financial system.

- *Second*, in passing Dodd-Frank, Congress did not supplant the state-based system of insurance regulation, and intended that insurance regulators have thorough representation on FSOC in order to ensure that the unique characteristics of that system could be brought to

bear on any decisions relating to FSOC's narrow mission of monitoring systemic risk and designating systemically important financial institutions for heightened supervision.

- *Finally*, the interests of insurance, and specifically insurance regulators, remain inadequately represented on FSOC; a problem that will continue for the foreseeable future.

Insurance as a Unique Product

Again, insurance products are fundamentally different from banking products and securities instruments. While banking and securities products are typically bought pursuant to a consumer's interest in gaining revenue, the purchase of insurance is often necessary for personal financial protection and to provide economic stability. Insurance policies involve up front payment in exchange for a legal promise to pay benefits upon a specified loss-triggering event in the future. Bank products involve money deposited by customers and are subject to withdrawal on demand, which the bank is liable for at any time. As such, unlike bank products, most insurance products are not subject to the risk of runs. For those asset management products that could be subject to some level of run risk, mitigating factors exist such as policy loan limitations, surrender/withdrawal penalties and additional taxes. Additionally, unlike banks, insurers typically maintain a diverse product mix, so only a portion of the company's products would be subject to the already reduced level of run risk. U.S. insurance companies are also subject to significant regulatory oversight including stringent capital requirements, limits on the nature and extent of their investments, and quarterly analysis and periodic examinations.

For these reasons, it is the view of the NAIC that traditional insurance products and activities do not typically create systemic risk. However, connections with other financial activities may expose some insurers to the impact of systemic risk, and certain products may provide a conduit for systemic risk. Insurers may also have exposure to systemic risk as part of large conglomerates, but stringent solvency requirements at the insurer level help to minimize the impact of that risk. Insurers are subject to robust regulation for solvency and investment activities, and have proven their resilience throughout the recent financial crisis. It is also important to remember the effectiveness of the regulators' ability to ring fence the insurers to protect policyholder assets. The longer term nature of insurance products makes this a much

more effective tool for insurers than banks or other entities, and enables regulators to wind down troubled insurers in an orderly manner.

The insurance market in the U.S. is truly unique in the world. In aggregate premium dollar numbers, the U.S. market is number one on a list of the largest jurisdictions in the world based on 2009 data – and actually larger than those ranked second through sixth combined. However, it is also true that much of the U.S. market is quite localized. There are far more firms writing insurance in the U.S. than in any other economy, and while there are some dominant firms and some concentration in niche product lines, overall market concentration is less pronounced than in most other sectors. In the context of FSOC's mission and systemic risk, this is important as competitors are more able to absorb company failures or disruptions in the marketplace.

There is also a wide variation in market size and complexity across the states. Three individual U.S. states rank in the top 10 jurisdictions worldwide as to premium volume, and nine states rank in the top 25. This variation in size and complexity, while not necessarily amenable to a one-size-fits-all approach to regulation, has allowed the U.S. state-based system of regulation to develop and implement best practice tools for a wide variety of insurance firms appropriate for their position in the market. This unique market structure has led to the evolution of a tailored system of regulatory oversight and supervision.

The current nationally coordinated state-based system of insurance regulation has been successfully providing sound, cooperative regulation and policyholder protections for 140 years and utilizes multiple sets of eyes and rigorous peer reviews to maximize regulatory scrutiny of insurers. A distinguishing aspect of the state-based insurance regulatory system is its collaborative culture. Working through the NAIC committee structure and processes, states have developed a system of insurance regulation that respects varying geographic and demographic considerations while requiring uniform financial reporting and uniform application of risk-based capital solvency oversight to guarantee that policyholders' funds are available when needed. All 50 states are currently accredited by the NAIC, which means they have had their financial regulatory frameworks and monitoring programs reviewed by independent teams and certified to meet certain baseline measures in order to ensure that jurisdictions can have confidence in other

states' financial oversight. This oversight includes: solvency regulation; rate and form regulation; market conduct examinations; monitoring competition and statistical reporting; residual market administration; consumer information and services; producer licensing; and anti-fraud protection.

Information sharing among regulators is a fundamental benefit of the insurance regulatory community that gathers as the NAIC. Through the NAIC committee structure, regulators are able to consult with each other, share regulatory information and approaches, and develop effective regulatory policies in the U.S. By way of example, in the past year, through the NAIC and its committee system, insurance regulators have made important changes to the Model Holding Company Act and Regulation that will provide regulators a clearer view of the operations of financial groups and their impact on any insurers within those groups. Regulators have enhanced the required securities lending disclosures, requiring additional transparency in an area that received attention during the financial crisis. They have also reduced regulatory reliance on credit ratings issued by the Nationally Recognized Statistical Rating Organizations by changing how commercial mortgage backed securities and residential mortgage backed securities are valued for determining risk based capital requirements.

It is also through the NAIC and its committee structure that insurance regulators work with international insurance regulators. Significantly, the NAIC is a founding member of the International Association of Insurance Supervisors (IAIS), which represents insurance regulators and supervisors of 190 jurisdictions in nearly 140 countries. Its goals are to promote effective and globally consistent supervision of the insurance industry and to contribute to global financial stability. It is at the IAIS Financial Stability Committee (where the NAIC and state insurance regulators have been quite active) that approaches are initially being developed to evaluate specific insurers and determine whether such entities will be considered Global Systemically Important Financial Institutions (GSIFIs).

Congressional Intent

As federal regulators and Members of Congress were negotiating the Dodd-Frank Act last year, the NAIC's overarching message to the authors was that "one size does not fit all." Insurance is

a different product and is regulated in a different manner than other financial products. Traditional insurance activities were not the sources of the systemic risk that enveloped our financial system in 2007 and 2008. Furthermore, insurance regulators already had well-developed systems for rehabilitating and, if necessary, unwinding troubled insurance companies while keeping policyholders whole.

Congress recognized these important differences in the Dodd-Frank Act. Insurance products do not fall under the jurisdiction of the Consumer Financial Protection Bureau. There are different circumstances under which insurance companies can be declared systemically risky and in need of winding down – and such activity would take place pursuant to state law.

In determining how insurance would be represented on the FSOC, Congress recognized that federal regulators may not fully understand these products and the ways in which these products have been, and will continue to be, successfully regulated by the states. As such, they ensured that three insurance experts would be placed on FSOC: an insurance expert appointed by the President and confirmed by the Senate; a state insurance commissioner; and the Director of FIO.

In regards to the selection of the state insurance commissioner designee to the Council, the Dodd-Frank Act mandates that a non-voting insurance regulator is to be appointed to FSOC through a process determined by all of the insurance regulators. In doing so, they recognized that the state insurance regulators, through the NAIC, have their own processes for making policy and choosing their representatives, and the drafters of Dodd-Frank deferred to those processes as a matter of law. In crafting the provision in this manner, we believe Congress intended for my position to represent the interests of the state insurance regulatory system – not just the interests of one state. At our most recent NAIC National Meeting, two former staff to the House Financial Services Committee deeply involved in drafting Dodd Frank– one a Democrat, and one a Republican – indicated that this was their understanding of Congressional intent as well.

The important role that Congress intended for state insurance regulators to play is further buttressed by Section 111(d) of the Dodd-Frank Act, which states:

> "The Council may appoint such special advisory, technical, or professional committees as may be useful in carrying out the functions of the Council, including an advisory committee consisting of State regulators, and the members of such committees may be members of the Council, or other persons, or both."

Similar language was included in FSOC's own bylaws, which are posted on the U.S. Treasury Department's website.

The authors of Dodd-Frank recognized the unique nature of insurance products. As such, they included language authorizing FSOC to consult with other state regulators in order to ensure that the Council has access to all available resources and expertise it needs to fully understand the insurance business model and insurance regulation.

Inadequate Insurance Expertise on FSOC

In the nearly nine months since FSOC began its official operations, the Council has been working at a furious pace. The Integrated Implementation Roadmap, the minutes of FSOC meetings, the proposed rules and studies available to the public on the FSOC website, and testimony here today from my colleagues on this panel can give you a good idea of the volume of work and progress that the council is making. But while FSOC engages in work that could impact insurers, two of our three insurance representatives are absent from the table, and I have been prohibited from utilizing available state regulatory resources, including engaging other state regulators, some of whom are active in very similar work in the international arena. Moreover, no advisory committees of state regulators have been established.

In the time since my appointment to the FSOC, I personally have attended four full FSOC meetings and, along with my very limited staff resources, have participated in innumerable meetings and conference calls of FSOC's nine committees. Unfortunately, my seat at the table is the only one having to do with insurance that has been filled. While my colleague, Illinois Insurance Director Michael McRaith, recently accepted an appointment to be the first Director of FIO, he will not begin his new job – and term on the Council – until June. While the new FIO

will serve as a source of information on insurance for federal entities, and help negotiate international agreements, the Dodd-Frank Act makes clear that FIO will not have any general supervisory or regulatory authority over the business of insurance and extremely narrow preemptive ability. Meanwhile, President Obama has yet to nominate the one voting member with insurance expertise to fill the third spot on the Council.

Making matters far worse, I have been restricted from consulting with my fellow insurance regulators on matters before FSOC, even though our regulatory system requires regulators to work collaboratively and share information with one another in confidential settings. The U.S. Treasury Department has taken a very narrow and, in my opinion and the NAIC's opinion, incorrect view of the authorizing language in Title I, Subtitle A of the Dodd-Frank Act by claiming that I represent the state of Missouri and not the insurance regulatory system. Such a position contradicts Congressional intent and the deference accorded to state insurance regulators in the explicit language of the statute itself. But most importantly, it contradicts logic and reason. Quite simply, FSOC should want – and the U.S. taxpayers should demand – all the regulatory resources and expertise that their regulators can provide to FSOC's important work in protecting the U.S. financial system. From the beginning, the state insurance regulators and the NAIC have been and continue to be willing to contribute to FSOC's important work relating to insurance.

After repeated requests to consult with regulators in other states and bring on additional staff resources, and after months of internal discussions with the U.S. Treasury Department on how we might be able to leverage the extensive state insurance regulatory resources potentially at my disposal, the NAIC officers, our C.E.O., Dr. Terri Vaughan, and I took a step we had initially hoped could be avoided, and sent a public letter to Treasury Secretary Geithner asking for him to rectify this issue. We have yet to receive a written reply.

While we have made limited progress with the U.S. Treasury Department on this issue in recent weeks, I am frustrated that it took six months, and repeated inquiries from both the NAIC and Congress, in order for the U.S Treasury Department to listen to our concerns. Even then, while I appreciate the accommodations made to date, they are simply not sufficient in light of the very

important work FSOC is engaged in. I am concerned that if progress on this front continues to be made at a similarly slow pace moving forward, decisions that will impact insurance companies, insurance consumers, and the financial stability of the U.S. will be made without adequate advice and counsel from those individuals who know insurance companies best and how such companies are already regulated.

Thank you again for the opportunity to testify before you today. I am happy to answer your questions.

For release on delivery
10:00 a.m. EDT
April 14, 2011

Statement by

J. Nellie Liang

Director

Office of Financial Stability Policy and Research

Board of Governors of the Federal Reserve System

Regarding the Financial Stability Oversight Council

before the

Subcommittee on Oversight and Investigations

of the

Committee on Financial Services

U.S. House of Representatives

Washington, D.C.

April 14, 2011

Chairman Neugebauer, Ranking Member Capuano, and other members of the subcommittee, thank you for the opportunity to testify on the Federal Reserve Board's role as a member of the Financial Stability Oversight Council (FSOC). The Federal Reserve is committed to working with the other Council members to advance the objectives that the Congress established for the Council and, more broadly, to implement effectively the regulatory reform measures set forth in the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).

Financial Stability Oversight Council

The Dodd-Frank Act created the FSOC and charged it with the important tasks of identifying and mitigating risks to the stability of the U.S. financial system, among other duties. The FSOC members represent a number of regulatory agencies that oversee a broad range of participants in U.S. financial markets. The Council is composed of 10 voting members and 5 nonvoting members. The Chairman of the Board of Governors of the Federal Reserve System is a voting member.[1] I am here testifying on behalf of the Chairman, as the director of the Board's recently created Office of Financial Stability Policy and Research.

As stated by the act, the purpose of the FSOC is "(A) to identify risks to the financial stability of the United States that could arise from the material financial distress or failure, or ongoing activities, of large, interconnected bank holding companies or nonbank financial companies, or that could arise outside the financial services marketplace; (B) to promote market

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[1] The U.S. Secretary of the Treasury serves as the FSOC chairman. Other voting members include the heads of the Office of the Comptroller of the Currency, the Securities and Exchange Commission, the Federal Deposit Insurance Corporation, the Commodity Futures Trading Commission, the Federal Housing Finance Agency, the National Credit Union Administration, the Bureau of Consumer Financial Protection, and an independent insurance expert appointed by the President. The latter two seats are in the process of being filled.

The five nonvoting seats are represented at present by participants from the Missouri Department of Insurance, Financial Institutions, and Professional Registration; the California Department of Financial Institutions; the North Carolina Department of the Secretary of State, Securities Division; the Federal Insurance Office; and the Office of Financial Research.

discipline, by eliminating expectations on the part of shareholders, creditors, and counterparties of such companies that the Government will shield them from losses in the event of failure; and (C) to respond to emerging threats to the stability of the United States financial system."[2] In carrying out its duties to mitigate risks, the FSOC is well-placed to address risks that do not fall clearly within the jurisdiction of a single agency. The FSOC also is expected to monitor domestic and international financial regulatory developments, as well as to advise the Congress and make recommendations to enhance the integrity, efficiency, competitiveness, and stability of the U.S. financial markets.

The FSOC has made meaningful progress in a number of areas since the act was passed less than a year ago. It has taken a number of important steps to promote interagency collaboration and has established the organizational structure and processes necessary to execute its duties. Importantly, the FSOC's internal organizational structure has been designed to leverage the expertise of the member agencies, and to promote a shared responsibility among the agencies for executing the duties of the FSOC. Special consideration has been given to promoting the sharing of information to help identify risks that could have the potential to become systemic, and facilitating coordination among the member agencies with respect to policy development, rulemaking, examinations, reporting requirements, and enforcement actions.

The FSOC's internal organizational structure consists of a Deputies Committee, which is composed of staff from all of the voting and nonvoting members, and six other standing committees, each charged with carrying out specific duties of the FSOC. The duties of these committees include: identifying nonbank financial firms and financial market utilities that could pose a systemic risk, making recommendations to financial regulatory agencies regarding

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[2] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1394 (2010), available at www.gpo.gov/fdsys/pkg/PLAW-111publ203/pdf/PLAW-111publ203.pdf.

heightened prudential standards for financial firms, making recommendations to enhance the prospects for orderly resolution of systemically important financial firms, collecting data and improving data reporting standards, and monitoring the financial system to identify potential threats to the financial stability of the United States. The Deputies Committee, under the direction of the FSOC members, coordinates and oversees the work of the other committees and aims to ensure that the FSOC fulfills its duties in an effective and timely manner.

In meeting its responsibilities under the Dodd-Frank Act, the FSOC and its member agencies have completed studies on limits on proprietary trading and investments in hedge funds and private equity funds by banking firms (the Volcker rule), on financial sector concentration limits, on the macroeconomic effects of risk retention, and on the economic effects of systemic risk regulation. It also has made progress toward establishing an analytical framework and processes to identify nonbank financial firms that could pose a threat to financial stability, including through the issuance of advance notices of proposed rulemakings on the designation of nonbank financial institutions and financial market utilities.

Additionally, the FSOC currently is working on preparing the inaugural FSOC annual financial stability report, scheduled to be publicly released later this year. As required by the statute, the annual report will discuss major financial and regulatory developments, potential risks to the financial system, and recommendations to mitigate potential risks.

Implementation of Regulatory Reform at the Federal Reserve

In addition to the Federal Reserve's role as a member of the FSOC, the Dodd-Frank Act gives the Federal Reserve other new important responsibilities. These responsibilities include supervising nonbank financial firms that are designated as systemically important by the Council, supervising thrift holding companies, and developing enhanced prudential standards--

including those for capital, liquidity, stress tests, single-counterparty credit limits, and living will requirements--for large bank holding companies and systemically important nonbank financial firms designated by the Council.

The Federal Reserve is working assiduously to meet its obligations under the Dodd-Frank Act. The act requires the Federal Reserve to complete more than 50 rulemakings and sets of formal guidelines as well as numerous reports and studies. We also have been assigned formal responsibilities to consult and collaborate with other agencies on a substantial number of additional rules, provisions, and studies. In order to meet our obligations in a timely manner, we are drawing on expertise and resources from across the Federal Reserve System in the areas of banking supervision, economic research, financial markets, consumer protection, payment systems, and legal analysis.

Members of the Federal Reserve's staff are working closely with the FSOC and the other regulators to strengthen systemic oversight. We are assisting the Council in the development of its analytical framework and procedures under which it will identify systemically important nonbank firms and financial market utilities and its systemic risk monitoring and evaluation processes. We are contributing to numerous studies and rulemakings. We are helping the new Office of Financial Research to develop potential data reporting standards to support the duty of the FSOC to monitor and evaluate systemic risk factors. We also are meeting regularly with staff of the other FSOC member agencies to discuss emerging risks to financial institutions and markets.

The Federal Reserve has made some internal changes to better carry out its responsibilities. Prior to the enactment of the Dodd-Frank Act, we had begun to reorient our supervisory structure to strengthen supervision of the largest, most complex financial firms,

through the creation of the Large Institution Supervision Coordinating Committee, a centralized, multidisciplinary body. Relative to previous practices, this body makes greater use of horizontal, or cross-firm, evaluations of the practices and portfolios of firms. It relies more on additional and improved quantitative methods for evaluating the performance of firms, and it employs the broad range of skills of the Federal Reserve staff more efficiently. In addition, we have reorganized to more effectively coordinate and integrate policy development for and supervision of systemically important financial market utilities. As the act recognizes, supervision should take into account the overall financial stability of the United States, in addition to the safety and soundness of each individual firm. Our revised internal organizational structure facilitates our implementation of this macroprudential approach to oversight.

More recently, we created an Office of Financial Stability Policy and Research at the Federal Reserve Board. This office contributes to the Federal Reserve System's multidisciplinary approach to the supervision of large, complex institutions. It helps identify and analyze potential risks to the broader financial system and the economy stemming from, among other things, potential asset price misalignment, excessive leverage, outsized financial flows, and structural vulnerabilities in financial markets. In addition, the office helps evaluate policies to promote financial stability.

It is also important that U.S. financial reforms be implemented in coordination with international efforts to establish consistent and complementary standards and to ensure effective oversight of internationally active firms and markets. We continue to work actively with our international counterparts on enhanced prudential standards for large financial institutions, to ensure that efforts to implement the Dodd-Frank Act are well aligned with efforts of the Group of Twenty, the Financial Stability Board, and the Basel Committee on Banking Supervision.

In closing, the Congress has given the FSOC an important mandate to identify and mitigate systemic risks. The Federal Reserve will work closely with our fellow regulators, the Congress, and the Administration to help the FSOC execute its responsibilities and promote financial stability in the United States.

For Release Upon Delivery
10:00 a.m., April 14, 2011

TESTIMONY OF

TIMOTHY W. LONG
SENIOR DEPUTY COMPTROLLER, BANK SUPERVISION POLICY
AND CHIEF NATIONAL BANK EXAMINER

OFFICE OF THE COMPTROLLER OF THE CURRENCY

Before the

SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS
FINANCIAL SERVICES COMMITTEE
UNITES STATES HOUSE OF REPRESENTATIVES

April 14, 2011

Statement Required by 12 U.S.C. § 250:

The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent the views of the President.

I. Introduction

Chairman Neugebauer, Ranking Member Capuano, and members of the Subcommittee, my name is Timothy Long and I am the Senior Deputy Comptroller for Bank Supervision Policy and Chief National Bank Examiner at the Office of the Comptroller of the Currency (OCC). In this role, I serve as the OCC's representative on the Financial Stability Oversight Council's Deputies Committee. I appreciate the opportunity to provide the OCC's perspectives on the functions and operations of the Financial Stability Oversight Council (FSOC or Council) and to briefly describe its major accomplishments to date.

Throughout the discussions and deliberations that led to the passage of the Dodd-Frank Wall Street and Consumer Protection Act (the Dodd-Frank Act), the OCC supported the creation of a council that would bring together the views, perspectives, and expertise of Treasury and all of the financial regulatory agencies to identify, monitor, and respond to systemic risk.[1] As my testimony will detail, Congress, with the passage of the Dodd-Frank Act, set forth very specific mandates regarding the role and function of FSOC in a number of areas, but certainly the overarching mission that Congress assigned to the Council is to identify risks to the financial stability of the United States, to promote market discipline, and to respond to emerging threats to the stability of the U.S. financial system.[2]

I believe FSOC enhances the agencies' collective ability to fulfill this critical mission by establishing a formal, structured process to exchange information and to

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[1] *See* April 4, 2009, Statement of John C. Dugan before the Committee on Banking, Housing, and Urban Affairs, United States Senate, pg. 2: "We believe many of the Administration's proposed reforms will strengthen the financial system and help prevent future market disruptions of the type we witnessed last year, including the following: Establishment of a Financial Stability Oversight Council."

[2] *See* Section 112(a)(1).

probe and discuss the implications of emerging market, industry, and regulatory developments for the stability of the financial system. Through the work of its committees and staff, FSOC also is providing a structured framework and metrics for tracking and assessing key trends and potential systemic risks. While the process and systems that FSOC has created are positive steps forward, I would offer two cautionary notes.

First, I believe that FSOC's success ultimately will depend not on its structure, processes, or metrics, but on the willingness and ability of FSOC members and staff to engage in frank and candid discussions about emerging risks, issues, and institutions. These discussions are not always pleasant as they can challenge one's longstanding views or ways of approaching a problem. But being able to voice dissenting views or assessments will be critical in ensuring that we are seeing and considering the full scope of issues. In addition, these discussions often will involve information or findings that will need further verification; that are extremely sensitive either to the operation of a given firm or market segment; or if misconstrued, that could undermine public and investor confidence and thereby create or exacerbate a potentially systemic problem. As a result, I believe that it is critical that these types of deliberations – both at the Council and staff level – be conducted in a manner that assures their confidential nature.

Second, even with fullest deliberations and best data, I believe it is inevitable that there will still be unforeseen events that may result in substantial risks to the system, markets, or groups of institutions. Business and credit cycles will continue. It is not realistic to expect that FSOC will be able to prevent such occurrences. However, I do believe FSOC provides a mechanism to communicate, coordinate, and respond to such

events so as to help contain and limit their impact, including, where applicable, the resolution of systemically important firms.

My testimony has three sections. First, I provide a brief summary of some of the specific mandates Congress has given to the FSOC. Next, I provide an overview of the FSOC's structure and operations. Finally, I discuss the Council's achievements to date.

II. FSOC's Statutory Mandates

FSOC's primary mission, as set forth in section 112 of the Dodd-Frank Act is to:

1) Identify risks to the financial stability of the United States that could arise from the material financial distress or failure, or ongoing activities, of large, interconnected bank holding companies or nonbank financial companies, or that could arise outside the financial services marketplace;
2) Promote market discipline, by eliminating expectations on the part of shareholders, creditors, and counterparties of such companies that the Government will shield them from losses in the event of failure; and
3) Respond to emerging threats to the stability of the U.S. financial system.

The Dodd-Frank Act assigns FSOC a variety of roles and responsibilities to carry out its core mission[3] that are described in greater detail throughout the Act. In some cases, the Council has direct and ultimate responsibility to make decisions and take actions. Most notable of these is the authority given to FSOC to determine that certain nonbank financial companies shall be supervised by the Federal Reserve Board and subject to heightened prudential standards, after an assessment as to whether material financial distress at such companies would pose a threat to the financial stability of the

[3] *See* section 112.

United States.[4] Similarly, the Council is charged with the responsibility to identify systemically important financial market utilities and payment, clearing, and settlement activities.

In addition, affirmation by two-thirds of the Council is required in those cases where the Federal Reserve determines that a large, systemically important financial institution poses a grave threat to the financial stability of the United States such that limitations on the company's ability to merge, offer certain products, or engage in certain activities are warranted, or if those actions are insufficient to mitigate risks, the company should be required to sell or otherwise transfer assets or off-balance items to unaffiliated entities.[5]

The FSOC is also empowered to collect information from member agencies and other federal and state financial regulatory agencies as necessary in order to monitor risks to the financial system, and to direct the Office of Financial Research under the Treasury Department to collect information directly from bank holding companies and nonbank financial companies.[6]

The Dodd-Frank Act also identified specific areas where the Council is to provide additional studies, including recommendations, to inform future regulatory actions. These include studies of the financial sector concentration limit applicable to large financial firms imposed by the Act;[7] proprietary trading and hedge fund activities;[8] the

[4] *See* section 113(a)(1).
[5] *See* section 121.
[6] *See* section 112.
[7] *See* section 622.
[8] *See* section 619.

treatment of secured creditors in the resolution process;[9] and contingent capital for nonbank financial companies.[10]

In other areas, the Council's role is more of an advisory body to the primary financial regulators. For example, the Dodd-Frank Act requires the Council to make recommendations to the Federal Reserve concerning the establishment of heightened prudential standards for risk-based capital, liquidity, and a variety of other risk management and disclosure matters for nonbank financial companies and large, interconnected bank holding companies supervised by the Board.[11] The Federal Reserve, however, retains the authority to supervise and set standards for these firms.[12] The Council is also given authority to review, and as appropriate, may submit comments to the Securities and Exchange Commission and any standard-setting body with respect to an existing or proposed accounting principle, standard, or procedure.[13] Similarly, FSOC is assigned a consultative role in several rulemakings by member agencies, including for all of the rules that the FDIC writes pursuant to Title II of the Dodd-Frank Act regarding the orderly liquidation of failing financial companies that pose a significant risk to the financial stability of the United States. The Council may also recommend to member agencies general supervisory priorities and principles[14] and issue nonbinding recommendations for resolving jurisdictional disputes among member agencies.[15]

I believe the varied roles and responsibilities that Congress assigned to the Council appropriately balance and reflect the desire to enhance regulatory coordination

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[9] *See* section 215.
[10] *See* section 115.
[11] *See* section 112.
[12] *See* section 165.
[13] *See* section 112.
[14] *See* section 112.
[15] *See* section 119.

for systemically important firms and activities while preserving and respecting the independent authorities and accountability of primary supervisors. For example, under section 120, FSOC has the authority to recommend to the primary financial agencies that they apply new or heightened standards and safeguards for a financial activity or practice conducted by firms under their respective jurisdictions should the Council determine that the conduct of such an activity or practice could create or increase the risk of significant liquidity, credit, or other problems spreading among financial institutions, the U.S. financial markets, or low-income, minority, or underserved communities. Each agency retains the authority to not follow such recommendations if circumstances warrant and the agency explains its reasons in writing to the Council.

III. FSOC Structure and Operations

The FSOC has established committees and subcommittees comprised of staff from the member agencies to help carry out its responsibilities and authorities. These groups report up through a Deputies Committee of senior staff from each agency. The Deputies Committee generally meets on a bi-weekly basis to monitor work progress, review pending items requiring consultative input, discuss emerging systemic issues, and help establish priorities and agendas for the Council. A Systemic Risk Committee and subcommittees on institutions and markets provide structure for the FSOC's analysis of emerging threats to financial stability. Five standing functional committees support the FSOC's work on the following specific provisions assigned to the Council: designations of systemically important nonbank financial companies and of financial market utilities and payment, clearing, and settlement activities; heightened prudential standards; orderly

liquidation authority and resolution plans; and data collection and analysis. OCC staff are active participants and contributors to each of these committees. In addition to these groups, the FSOC also has an informal interagency legal staff working group that assists with various legal issues concerning the Council's operations and proceedings. Each of these committees and work groups is supported by staff from Treasury.

IV. Accomplishments To-Date

Since its creation with the enactment of the Dodd-Frank Act, the Council has met four times, with meetings occurring approximately every six weeks. As with any newly formed body, a large proportion of the Council's early work was focused on the necessary administrative rules and procedures that will govern the Council's operations. In addition to the creation and staffing of the aforementioned committees, this work has included the adoption of a transparency policy for Council meetings; rules of organization that describe the Council's authorities, organizational structure, and the rules by which the Council takes action; establishment of a framework for coordinating regulations or actions required by the Dodd-Frank Act to be completed in consultation with the Council; approval of an initial operating budget for the Council; and the publication of a proposed rulemaking to implement the Freedom of Information Act requirements as it pertains to Council activities.

The Council has also taken action on a number of substantive items directly related to its core mission and mandates. These include the following:

- *Study and Recommendations Regarding Concentration Limits on Large Financial Companies*[16] – Section 622 of the Dodd-Frank Act establishes a financial sector concentration limit that generally prohibits a financial company from merging, consolidating with, or acquiring another company if the resulting company's consolidated liabilities would exceed 10 percent of the aggregate consolidated liabilities of all financial companies. Pursuant to the mandate in section 622, on January 18, 2011, the Council approved the publication of this study of the extent to which the concentration limit would affect financial stability, moral hazard in the financial system, the efficiency and competitiveness of U. S. financial firms and financial markets, and the cost and availability of credit and other financial services to households and businesses in the United States. The study concludes that the concentration limit will have a positive impact on U.S. financial stability. It also makes a number of technical recommendations to address practical difficulties likely to arise in its administration and enforcement, such as the definition of liabilities for certain companies that do not currently calculate or report risk-weighted assets.
- *Study and Recommendations on Prohibitions on Proprietary Trading and Certain Relationships with Hedge Funds and Private Equity Funds*[17] – As mandated by the Dodd-Frank Act, FSOC conducted a study on how best to implement section 619 of the Act (commonly known as the "Volcker Rule"), which is designed to improve the safety and soundness of our nation's banking system by prohibiting propriety trading

[16] A copy of the study is available at: http://www.treasury.gov/initiatives/Documents/Study%20on%20Concentration%20Limits%20on%20Large%20Firms%2001-17-11.pdf.

[17] A copy of the study is available at: http://www.treasury.gov/initiatives/Documents/Volcker%20sec%20%20619%20study%20final%201%2018%2011%20rg.pdf.

activities and certain private fund investments. To help formulate its recommendations, the Council published a Notice and Request for Information in the *Federal Register* on October 6, 2010, and received more than 8,000 comments from the public, Congress, and financial services market participants. Key themes in those comments urged agencies to:

- Prohibit banking entities from engaging in speculative proprietary trading or sponsoring or investing in prohibited hedge funds or private equity funds;
- Define terms and eliminate potential loopholes;
- Provide clear guidance to banking entities as to the definition of permitted and prohibited activities; and
- Protect the ability of banking firms to manage their risks and provide critical financial intermediation services and preserve strong and liquid capital markets.

After careful consideration of these comments, on January 18, 2011, the Council approved publication of its study and recommendations that are intended to help inform the regulatory agencies as they move forward with this difficult and complex rulemaking. The study endorses the robust implementation of the Volcker Rule and makes ten broad recommendations for the agencies' consideration.[18]

As the Acting Comptroller noted at the Council meeting at which this matter was considered, the OCC believes this study strikes a fair balance between identifying considerations and approaches for future rulemaking, and being overly prescriptive. As

[18] *See:* Financial Oversight Council, *Study & Recommendations on Prohibitions on Proprietary Trading & Certain Relationships with Hedge Funds & Private Equity Funds*, (January 2011) at 3.

noted earlier, this is an area where Congress chose to make a careful and, in my view, judicious distinction in authorities – requiring the Council to conduct the study and make recommendations, but leaving responsibility for writing the implementing regulations to the relevant supervisory agencies. Recognizing this distinction is essential to the process because the rulewriting agencies are required by law to invite – and consider—public comments as they develop the implementing regulations. This means the agencies must conduct the rulemaking without prejudging its outcome. We and the other agencies are in the midst of developing the proposed implementing rule and will be soliciting comment on all aspects of it when it is published.

- *Proposed Rulemakings on Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies* – As noted earlier, in contrast to the Volcker Rule where the Council's role is primarily one of an advisory body, the Council is directly given authority under the Dodd-Frank Act to designate systemically important nonbank financial firms for heightened supervision. On October 1, 2010, the Council approved for publication an advance notice of proposed rulemaking (ANPR) that sought public comment on the implementation of this provision of the Dodd-Frank Act. Approximately 50 comments were received on the ANPR. On January 18, 2011, the Council approved publication of a notice of proposed rulemaking (NPRM) that outlines the criteria that will inform the Council's designation of such firms and the procedures the FSOC will use in the designation process. The NPRM closely follows and adheres to the statutory factors established by Congress for such designations. The framework proposed in the NPRM for assessing systemic importance is organized around six broad categories, each of which reflects a different dimension of a firm's potential to experience material financial

distress, as well as the nature, scope, size, scale, concentration, interconnectedness, and mix of the company's activities. The six categories are: size, interconnectedness, substitutability, leverage, liquidity, and regulatory oversight. The comment period for this NPRM closed on February 25, 2011. The FSOC is currently in the process of reviewing the comments received and, in consultation with the members, is beginning to formulate a final rule. As noted in the NPRM, the Council expects to begin assessing the systemic importance of nonbank financial companies shortly after adopting a final rule. Consistent with statutory provisions, the designation of a nonbank firm as systemically important will require consent by no fewer than two-thirds of the voting members of the Council, including the affirmative vote of the Chairperson of the Council. Before being designated, a firm will be given a written notice that the Council is considering making a proposed determination with opportunity to submit materials applicable to such a determination. Firms also are provided the right to a hearing once they receive a written notice of proposed determination.

- *Proposed Rulemakings on Authority to Designate Financial Markets Utilities as Systemically Important* – Section 804 of the Dodd-Frank Act provides FSOC with the authority to identify and designate as systemically important a financial market utility (FMU) if FSOC determines that the failure of the FMU could create or increase the risk of significant liquidity or credit problems spreading among financial institutions or markets and thereby threaten the stability of the U.S. financial system. On December 21, 2010, the Council published an ANPR regarding the designation criteria in section 804. The Council received 12 comments in response to the ANPR. At its March 18, 2011, meeting, the Council approved the publication of a NPRM that describes the criteria,

analytical framework, and process and procedures the Council proposes to use to designate an FMU as systemically important. The NPRM includes the statutory factors the Council is required to take into consideration and adds subcategories under each of the factors to provide examples of how those factors will be applied. The NPRM also outlines a two-stage process for evaluating and designating an FMU as systemically important. This process includes opportunities for a prospective FMU to submit materials in support of or opposition to a proposed designation. Consistent with statutory provisions, any designation of an FMU will require consent by the same supermajority and affirmative vote procedure described above for designation of nonbank firms. The Council must also engage in prior consultation with the Federal Reserve Board and the relevant federal financial agency that has primary jurisdiction over the FMU.

- *Systemic Risk Monitoring* – The Council and its committees are also making strides in providing a more systematic framework for identifying, monitoring, and deliberating potential systemic risks to the financial stability of the United States. Briefings and discussions on potential risks and the implications of current market developments – such as recent events in Japan, the Middle East, and Northern Africa – on financial stability are a key part of the closed deliberations of each Council meeting, allowing for a free exchange of information and insights. As part of these discussions, members assess the likelihood and magnitude of the risks, the need for additional data or analysis, and whether there is a current need to supplement or redirect current actions and supervisory oversight to mitigate these risks. In addition, the Council's Data Subcommittee has overseen the development and production of a standard set of analyses that FSOC members receive prior to each Council meeting that summarize current conditions and

trends related to the macroeconomic and financial environment, financial institutions, financial markets, and the international economy.

- *Annual Systemic Risk Report* – Section 112 of the Dodd-Frank Act requires the FSOC to annually report to and testify before Congress on the activities of the Council; significant financial market and regulatory developments; potential emerging threats to the financial stability of the U.S.; all determinations regarding systemically important nonbank financial firms or financial market utilities or payment, clearing and settlement activities; any recommendations regarding supervisory jurisdictional disputes; and recommendations to enhance the integrity, efficiency, competitiveness, and stability of U.S. financial markets, to promote market discipline, and to maintain investor confidence. Work is under way in preparing the first of these reports and much of the aforementioned work on systemic risk monitoring will help shape its content. It is our understanding that Treasury plans to issue the report later this year.

V. Conclusion

The Dodd-Frank Act has assigned FSOC important duties and responsibilities to help promote the stability of the U.S. financial system. The issues that the Council will confront in carrying out these duties are, by their nature, complex and far-reaching in terms of their potential effects on our financial markets and economy. Developing appropriate and measured responses to these issues will require thoughtful deliberation and debate among the members. The OCC is committed to providing its expertise and perspectives and in helping the Council achieve its mission.

EMBARGOED UNTIL DELIVERY

STATEMENT OF

ARTHUR J. MURTON
DIRECTOR, DIVISION OF INSURANCE AND RESEARCH
FEDERAL DEPOSIT INSURANCE CORPORATION

on

OVERSIGHT OF THE FINANCIAL STABILITY OVERSIGHT COUNCIL

before the

SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS
HOUSE FINANCIAL SERVICES COMMITTEE

April 14, 2011
2128 Rayburn House Office Building

Chairman Neugebauer, Ranking Member Capuano, and members of the Subcommittee, thank you for the opportunity to testify today on behalf of the Federal Deposit Insurance Corporation on issues related to the Financial Stability Oversight Council (FSOC).

The recent financial crisis exposed shortcomings in our regulatory framework for monitoring risk and supervising the financial system. Insufficient capital at many financial institutions, misaligned incentives in securitization markets and the rise of a largely unregulated shadow banking system permitted excess and instability to build up in the U.S. financial system. These conditions led directly to the liquidity crisis of September 2008 that froze our system of intercompany finance and contributed to the most severe economic downturn since the Great Depression.

At the same time, the pre-2010 regulatory framework focused regulators narrowly on individual institutions and markets within their jurisdiction. No one had a firm grasp of the big picture of overall risk in the financial system. This allowed supervisory gaps to grow and created an incentive for companies to engage in regulatory arbitrage to find the weakest oversight or, worse, move to parts of the system that were virtually unregulated. In addition to these regulatory gaps, the absence of a resolution process for systemically important non-bank financial companies left financial regulators with limited options for addressing problems facing such firms, creating a no-win dilemma for policy-makers: bail out these companies or expose the financial system to destabilizing liquidations through the normal bankruptcy process.

The landmark Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) creates a comprehensive new regulatory and resolution regime that is designed to avoid the severe economic consequences of economic instability. The Dodd-Frank Act gives regulators new tools to limit risk in individual financial institutions and transactions, enhances the supervision of large non-bank financial companies, and facilitates the orderly closing and liquidation of large banking organizations and non-bank financial companies in the event of failure.

The FSOC is one of the most important new tools created by the Dodd-Frank Act and is designed to fill the gaps in regulatory oversight. For the first time, one entity has the collective accountability for identifying and constraining risks to the financial system as a whole. My testimony will review the FDIC's participation on the FSOC, identify FSOC-related issues that are of particular importance to the FDIC, and discuss actions of the FSOC to date.

Background and FDIC's Participation in the FSOC

Among other things, the Dodd-Frank Act directs the FSOC to facilitate regulatory coordination and information sharing among its members regarding policy development, rulemaking, supervisory information, and reporting requirements. The FSOC is also responsible for determining whether a nonbank financial company should be supervised by the Board of Governors of the Federal Reserve System (Federal Reserve) and subject to prudential standards, and for designating financial market utilities (FMUs) and payment, clearing, or settlement activities that are, or are likely to become, systemically

important.[1] The term systemically important financial institution, or SIFI, is used to describe nonbank financial companies that the Council has determined should be supervised by the Federal Reserve and subject to prudential standards. The FSOC has the authority to recommend more stringent risk management standards for SIFIs and large, interconnected bank holding companies, and can ultimately determine to break up firms that pose a "grave threat" to financial stability. The Dodd-Frank Act also directs the FSOC to issue specialized reports and conduct various studies.

In order to complete its day-to-day work, the FSOC has established a committee structure. The Deputies Committee, which is comprised of senior officials from each member agency, coordinates and oversees staff assigned to FSOC-related issues. Among other things, the Deputies Committee is responsible for sharing information on proposed policies and rules among member agencies.

Since the FSOC's main responsibilities revolve around systemic risk monitoring and mitigation, the FSOC created a Systemic Risk Committee and two subcommittees on which the FDIC and other members serve – "Financial Institutions" and "Financial Markets." The Systemic Risk Committee is primarily responsible for making recommendations to the FSOC regarding significant financial market and regulatory developments and potential emerging threats to the financial stability of the U.S. The Systemic Risk Committee also will help the FSOC carry out its responsibilities to report on its progress to Congress. The Dodd-Frank Act requires that the FSOC produce annual

[1] Bank holding companies with total consolidated assets of $50 billion or more are automatically subject to enhanced prudential standards established by the Federal Reserve Board.

financial stability reports and that each voting member submit a signed statement stating whether the member believes that the FSOC is taking all reasonable actions to mitigate systemic risk.

The FSOC also has five standing functional committees, with each committee focusing on one of the following key issues: 1) designation of nonbank financial companies for supervision by the Federal Reserve; 2) designation of FMUs as systemically important; 3) recommendation to the Federal Reserve of heightened prudential standards applicable to SIFIs and large, interconnected bank holding companies; 4) orderly liquidation authority and resolution plans; and 5) data. There are also ad hoc groups for special issues and reports, such as a group currently working on the Volcker Rule, which under the Dodd-Frank Act prohibits proprietary trading and acquisition of an interest in hedge or private equity funds by insured depository institutions.

The FDIC has representatives on these five standing functional committees. In addition to participating on FSOC committees, the FDIC has a number of internal work streams, which focus on specific risk issues, policies, studies, and regulations.
A particular area of interest for the FDIC -- and a source of a significant number of the FDIC's Dodd-Frank Act-related rulemakings -- stems from the Act's mandate to end "Too Big to Fail." This includes our Orderly Liquidation Authority under Title II of the Act, our joint rulemaking with the Federal Reserve on requirements for resolution plans (or "living wills") that will apply to SIFIs and bank holding companies with total

consolidated assets of $50 billion or more, and the development of criteria for determining which firms will be designated as SIFIs by the FSOC.

SIFI Designation

An important responsibility of the FSOC is to develop criteria for identifying nonbank financial companies that will be subject to enhanced Federal Reserve supervision and therefore, subject to the resolution plan requirements. To protect the U.S. financial system, it is essential that SIFIs are identified promptly and receive the proper supervision so we do not find ourselves with a troubled firm that is placed into Title II liquidation without having a resolution plan in place.

The Dodd-Frank Act specifies a number of factors that can be considered when designating a nonbank financial company for enhanced supervision by the Federal Reserve, including: leverage; off-balance-sheet exposures; and the nature, scope, size, scale, concentration, interconnectedness and mix of activities. The FSOC will develop a combination of qualitative and quantitative measures of potential risks to U.S. financial stability posed by an individual nonbank institution. Once these measures are agreed upon, the FSOC may need to request data or information that is not currently collected or otherwise available in public filings.

Recognizing the need for accurate, clear, and high quality information, Congress granted the FSOC the authority to gather and review financial data and reports from nonbank financial companies and bank holding companies, and if appropriate, request

that the Federal Reserve conduct an exam of the company for purposes of making a systemic designation. By collecting information in advance of a designation, the FSOC can be much more judicious in determining which firms it designates as SIFIs. This will minimize both the threat of an unexpected systemic failure and the number of firms that will be subject to additional regulatory requirements under Title I of the Act.

Last October, the FSOC issued an Advance Notice of Proposed Rulemaking regarding the criteria that should inform the FSOC's designation of nonbank financial companies. The FSOC received approximately 50 comments from industry trade associations, individual firms, and individuals. On January 26, 2011, the FSOC issued a Notice of Proposed Rulemaking describing the criteria that will inform the FSOC's designation of nonbank financial companies and the processes and procedures established under the Dodd-Frank Act.

The comment period closed on February 25, 2011, and the FSOC received 43 comments. Many commenters requested that specific metrics be made available for public comment and included in the text of the rule.

The FSOC is committed to adopting a final rule as expeditiously as possible, with the first designations to occur shortly thereafter. The FDIC believes the final rule should be more descriptive as to the metrics that the Council will be considering.

Conclusion

The FDIC believes that the FSOC members are committed to the success of the Council, and we have been impressed with the quality of staff work in preparation for the meetings as well as the rigor and candor of the discussions. We also believe that the FSOC has provided a useful means for agencies to jointly write rules required by the Dodd-Frank Act and to seek input from other agencies on independent rules. The FDIC strongly supports the FSOC's collective approach to identifying and responding to risks.

The FSOC is an important new tool for financial regulators to close supervisory gaps and to maintain financial stability by identifying and dealing with risks before they pose a serious threat to the financial system. The FDIC is actively involved in many aspects of the FSOC, but is particularly focused with ending the chaos and costs associated with "Too Big to Fail." Working within the FSOC framework, the FDIC intends to expeditiously complete rulemakings and exercise its new authorities related to orderly liquidation authority and resolution plans so market participants will know the rules, and so that as stewards of the financial system, we will prevent a repeat of the recent financial crisis.

Thank you again for the opportunity to testify and I would be pleased to answer any questions.

U.S. House of Representatives Committee on Financial Services
Subcommittee on Oversight and Investigations
"Oversight of the Financial Stability Oversight Council"
April 14, 2011

Responses to Questions for the Record of Robert W. Cook, Director of Division of Trading and Markets, Securities Exchange Commission

SEC-CFTC Coordination

1. **During questioning, Chairman Gensler agreed that the proposed rules from CFTC and SEC are currently not consistent with respect to a variety of significant Swap Execution Facility requirements. Since the hearing what steps has the SEC taken to ensure harmonization across SEF rulemakings, particularly with respect to avoiding inefficient and detrimental effects to dually regulated products (for example, Credit Default Swaps)?**

   Since enactment of the Dodd-Frank Act, SEC staff has engaged in regular discussions with their counterparts at the CFTC about the various common statutory provisions applicable to security-based swap execution facilities (SEFs) and our respective approaches to implementing those provisions. In a number of areas, the two approaches are quite similar. For example, both proposals include similar filing processes for rule changes and new products. Some differences between the proposals, however, reflect differences between the products regulated by the two agencies and the overall regulatory frameworks that they administer.

   The comment period for the SEC's proposal relating to the registration and regulation of SEFs has closed, and the SEC staff is reviewing commenters' input on both the SEC and CFTC proposals, including comments suggesting ways in which the proposed rules could be further harmonized. For example, commenters identified the registration process as a topic suitable for further harmonization, and so we are looking at ways in which the two agencies' proposed processes can be brought closer together. In addition, SEC staff is particularly mindful of the regulatory burdens that could be placed on those entities that will be dually registered as SEFs with the SEC and CFTC. We will continue to work with our CFTC counterparts to assess ways in which we can further harmonize our respective approaches, streamline our rules and minimize the regulatory burdens for SEFs while accomplishing the objectives of the Dodd-Frank Act.

2. **Section 112 of Dodd-Frank lists FSOC duties including the requirement to "facilitate information sharing and coordination among the member agencies and other Federal and State agencies regarding domestic financial services policy development, rulemaking, examinations, reporting requirements, and enforcement actions." Given this requirement could you explain why there are conflicts between SEC and CFTC proposed rules on whistleblower protection and swap execution facilities just to name two?**

Since enactment of the Dodd-Frank Act, SEC staff has engaged in regular discussions with their counterparts at the CFTC about various common statutory provisions in an effort to minimize conflicts, even where such provisions do not require joint rulemaking.

Section 922 of the Dodd-Frank Act establishes the SEC's whistleblower program, while Section 748 establishes the whistleblower program for the CFTC. Although certain of the provisions contained in Section 922 are similar to those set forth in Section 748, there are material differences. For example, Section 922 (the SEC's statutory provision) provides for longer statutes of limitations, larger recoveries for victims of retaliation by doubling the back pay due to a wrongfully terminated whistleblower, and a larger working whistleblower fund. During the rulemaking process, SEC staff had several conversations with the CFTC staff in order to share ideas and discuss potential implications of certain rule provisions for the various stakeholders, including whistleblowers, entities and our respective agencies. Ultimately, of course, the SEC and CFTC are separate agencies with different missions and regulatory responsibilities. The SEC's final rules reflect what the Commission considered necessary to implement an effective whistleblower program in light of the particulars of Section 922 and our agency's mission.

Section 763 of the Dodd-Frank Act establishes the legal framework for the implementation of the regulation of SEFs under SEC jurisdiction. Section 763 is very similar, but not identical, to Section 733 relating to SEFs under the CFTC's jurisdiction. SEC and CFTC staff have engaged in regular discussions concerning the SEF-related provisions and our respective approaches toward implementing them. In many cases, these discussions have led to similar approaches being proposed, although there are some differences in the two agencies' proposed SEF rulemakings reflecting differences in the products the agencies regulate and the overall regulatory framework they administer.

In connection with preparing final rules, SEC staff will continue working with CFTC staff to develop as harmonized an approach to SEFs as practicable. However, in certain areas, the Dodd-Frank Act's application to security-based swaps may ultimately be different from its application to the swaps that will be regulated by the CFTC, as the relevant commissions, products, entities and markets themselves are different, and there also are practical differences between how swaps and security-based swaps are traded. In light of these circumstances, differing approaches to regulation of swaps and security-based swaps may be warranted in some instances.

3. **How has the FSOC materially improved coordination between the SEC and other regulators as to rulemaking in your respective jurisdictions? In the absence of the FSOC, would the SEC still coordinate with the CFTC on joint rulemakings and rules addressing the same or similar financial products?**

SEC staff has been working closely with CFTC staff both through FSOC and independently on joint rulemakings and rules addressing the same or similar financial products. This coordination has been ongoing. For example, in implementing Title VII of the Dodd-Frank Act, SEC staff is meeting regularly, both formally and informally, with the staffs of the

CFTC, Federal Reserve Board, and other financial regulators. In particular, SEC staff has consulted and coordinated extensively with CFTC staff in the development of the proposed derivatives rules. FSOC provides another valuable forum for facilitating such coordination among representatives of all the financial regulators on a variety of topics, particularly related to identifying risks, regulatory gaps and possible structural weaknesses in the financial system.

Global Competitiveness

1. **Is the SEC focused on achieving the consistency of new execution requirements for swaps and over the counter derivatives in competing markets in non-U.S. jurisdictions? Is the SEC concerned that more restrictive execution requirements will drive execution overseas to the detriment of U.S. financial markets and away from the supervision contemplated by the Dodd Frank Act?**

   The Dodd-Frank Act mandates that security-based swap transactions that are required to be cleared through a clearing agency be executed on an exchange or a swap execution facility (SEF), provided that an exchange or SEF makes the security-based swap available to trade. A SEF is defined as a trading system or platform in which multiple participants have the ability to execute or trade security-based swaps by accepting bids and offers made by multiple participants in the facility or system.

   A number of foreign jurisdictions, but not all, are in the process of adopting derivatives legislation and implementing regulations. Compared to the United States, these jurisdictions are at much earlier stages of development in their efforts, particularly with respect to trading requirements.

   In addition to our consultation and coordination with the CFTC and other U.S. authorities in writing SEF-related rules, we have been engaged in ongoing bilateral and multilateral discussions with foreign regulators and have been speaking with many foreign and domestic market participants in order to better understand what areas of derivatives regulation pose arbitrage opportunities. We have solicited and welcome comments on our proposed rulemakings regarding the potential impact they may have on the position of the U.S. derivatives markets, especially comments that offer suggestions for mitigating regulatory arbitrage opportunities while achieving the goals of Title VII of the Dodd-Frank Act. While our ongoing development of execution rules gives us an opportunity to shape the derivatives regulatory landscape, we also face challenges in negotiating with other countries' regulators, as they have limited scope to commit to regulatory harmonization before their legislative and regulatory frameworks have been established.

   We will continue to work with our counterparts in other jurisdictions to foster the development of common frameworks and coordinate regulatory efforts as much as possible with a view to mitigating systemic risk and preventing regulatory arbitrage.

2. **How will the SEC ensure that U.S. firms will have equal access to foreign capital markets as foreign firms will have to U.S. markets?**

SEC staff is committed to working with our colleagues at the other financial regulators to address issues of international competitiveness in connection with the implementation of the Dodd-Frank Act.

For example, many foreign jurisdictions, including the European Union, are in the process of adopting derivatives legislation and implementing regulations, but are at much earlier stages of development in their efforts than is the United States. While there are a range of views internationally on the appropriate level of derivatives regulation, the SEC has been actively engaged in ongoing bilateral and multilateral discussions with foreign regulators regarding both the direction of international derivatives regulation generally as well as the SEC's efforts to implement Title VII's requirements.

Among other steps, the SEC, along with the CFTC, the United Kingdom Financial Services Authority, and the Securities and Exchange Board of India, is co-chairing the International Organization of Securities Commissions Task Force on OTC Derivatives Regulation (Task Force). One of the primary goals of this Task Force is to work to develop consistent international standards related to OTC derivatives regulation. In addition, on behalf of IOSCO, the SEC, along with the European Commission and an international organization of central banks, co-chairs the Financial Stability Board's OTC Derivatives Working Group (FSB Working Group). The CFTC and Federal Reserve Board also are members of the FSB Working Group.

These and other bilateral and multilateral efforts serve to keep the SEC informed about emerging similarities or differences in potential approaches to derivatives regulation and provide us with an opportunity to foster the development of common frameworks and coordinate regulatory efforts with our counterparts in other jurisdictions as much as possible with a view to mitigating systemic risk and preventing regulatory arbitrage.

3. **To your knowledge, has any nation other than the United States adopted a rule like the Volcker Rule? In its capacity as coordinator of the final rules that implement the Volcker Rule, how will the Treasury, Secretary as Chairperson of the FSOC, ensure that those rules do not place the United States at a competitive disadvantage?**

To our knowledge, the United States is the only nation that has enacted a statutory provision like the Volcker Rule. We understand, however, that in an April 2011 interim report, the UK Independent Commission on Banking contemplated a measure that would "ring-fence" a bank's UK retail banking activities from wholesale and investment banking activities. Although this approach would not impose the same restrictions as the Volcker Rule, the report noted that the ring-fencing measure is intended to address many of the same concerns as the Volcker Rule, such as curtailing "government guarantees and the instability they can create by subsidizing risk taking." The report states that the contemplated ring-fence would:

> "help shield UK retail activities from risks arising elsewhere within the bank or wider system, while preserving the possibility that they could be saved by the rest of the bank. And in combination with higher capital standards it could curtail taxpayer exposure and thereby sharpen commercial disciplines on risk taking."

The interim report notes that a Volcker Rule-like restriction would likely not have a significant impact in the UK because the activities of dedicated proprietary trading units within UK universal banks typically have represented a very small component of bank assets.

The FSOC study sought public comment as to the issue of global competiveness, and we expect to seek extensive comment on the same as part of the rulemaking proposal we will recommend to the Commission.

4. **Has a cost-benefit analysis been performed on the impact on the capital markets due to a potential loss of liquidity or efficiencies in providing liquidity if the Volcker Rule sweeps too broadly and impedes legitimate market making and asset management activity?**

   We have not yet proposed rules to implement the provisions of the Volcker Rule that all within our authority. In recommending proposed rulemaking in this area, the staff will consider and be informed by its estimation of the costs and benefits of the proposed rule.

5. **The final rules that implement the Volcker Rule are due to be published this October. Presumably, draft rules will be issued fairly shortly. Given this extremely tight timeline, how has the Chairman of the FSOC, in its capacity as coordinator of the final rules that implement the Volcker Rule, worked with your agency to ensure that public comments are taken fully into account in the final rules?**

   The public's views on the Volcker Rule have been – and continue to be – an important part of the SEC staff's dialogue with the staffs of the other FSOC agencies. In October 2010, in conjunction with the FSOC study on the Volcker Rule, FSOC published in the Federal Register a request for public comment on the Volcker Rule. FSOC received more than 8,000 comments in response, which the FSOC considered in its study. After the study was published, we and other agencies have continued to welcome and consider public input on the Volcker Rule. To that end, the Commission has an open comment file devoted to the Volcker Rule, and we have considered comments that were submitted to that file. In addition, SEC staff has had numerous in-person meetings with the public regarding the Volcker Rule. As we work on the implementing rules, we will continue to take public views on the Volcker Rule into account.

6. **Is there potential for the Volcker provisions in Section 619 to cause less regulated, "shadow banking system" participants to become primary providers of market liquidity? Is the SEC prepared to address this as a potential market or systemic risk if significant liquidity in U.S. markets is diverted either to less regulated entities or to non-U.S. markets?**

   SEC staff does not expect the Volcker Rule to cause so-called "shadow banking participants" to become the primary providers of market liquidity. As the FSOC study recognized, the Volcker Rule provides for permitted activities that aim to ensure that the economy and consumers continue to benefit from robust and liquid capital markets and financial

intermediation. According to the FSOC study, the permitted activities represent "core banking functions," such as market making, asset management, underwriting, and transactions in government securities.

At the same time, because the purpose of the Volcker Rule is generally to prohibit banking entities from engaging in more speculative proprietary trading and investing in or sponsoring hedge funds and private equity funds, certain such activities will likely move to other entities not covered by the Volcker Rule. However, because such entities would not have access to benefits from federal insurance on customer deposits or access to the discount window, trading by these entities may not implicate the systemic risks that the Volcker Rule was intended to address.

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Gary Gensler, Chairman, Commodity Futures Trading Commission (CFTC)

Public Debt

1. Is the public debt of the United States a risk that merits evaluation in the annual report to Congress of the Financial Stability Oversight Council? Please explain why or why not you maintain this position.

Response: I concurred in the FSOC's finding that the nation's growing public debt is on an unsustainable path, and that a credible plan is required to change its course.

CFTC-SEC Coordination

1. Has Secretary Geithner, Chairman of the Financial Stability Oversight Council, played a role in helping the CFTC coordinate with other regulators on joint rulemakings or rulemakings covering similar subject areas?

Response: The CFTC's Dodd-Frank Act staff rulemaking teams and the Commissioners are all working closely with fellow regulators and officials at the Department of the Treasury. CFTC staff have had more than 600 meetings with their counterparts at other agencies and have hosted numerous public roundtables with staff from other regulators to benefit from the open exchange of ideas. The teams' coordination includes sharing memos, term sheets and draft work product. The close working relationships have benefited the rulemaking process. Commission staff will continue to engage with their colleagues at the other agencies as we proceed to develop and consider final rules.

2. During questioning, you agreed that the proposed rules from CFTC and SEC are not consistent with respect to a variety of significant Swap Execution Facility requirements. Since the hearing what steps has the CFTC taken to ensure harmonization across SEF rulemakings, particularly with respect to avoiding inefficient and detrimental effects to dually regulated products (for example, Credit Default Swaps)?

Response: CFTC and SEC staff involved in the Swap Execution Facility and Securities-Based Swap Execution Facility rulemakings have worked closely together throughout the process of implementation. The initial comment period on the CFTC proposed rule closed on March 8, 2011. After substantially completing the proposed rule phase of Dodd-Frank Act implementation, the Commission re-opened or extended many comment periods. In the case of the SEF rulemaking, the public was given 30 additional days to submit comments, having seen the entire mosaic of proposed rules. The CFTC benefits from review of public comments submitted in response to the rulemakings of both agencies. The two agencies will continue to collaborate.

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Global competitiveness

1. Swaps are traded on an international basis and customers have the choice to transact in the jurisdiction offering the best terms for swap execution. What can you tell us about the coordination that you are having with the SEC and foreign regulators to ensure there is a level playing field for swaps transactions among well-regulated markets? Is there a concern that transactions will migrate to foreign markets that operate under a more favorable regulatory environment?

Response: **The CFTC's Dodd-Frank staff rulemaking teams and the Commissioners are all working closely with the SEC and all fellow regulators. CFTC staff have held more than 600 meetings with their counterparts at other agencies and have hosted numerous public roundtables with staff from other regulators to benefit from the open exchange of ideas. Commission staff will continue to engage with their colleagues at the SEC and other agencies as we proceed to develop and consider final rules and ensure harmonization among agencies. Our international counterparts also are working to implement needed reform. We are actively consulting and coordinating with international regulators to promote robust and consistent standards and to attempt to avoid conflicting requirements in swaps oversight. Section 722(d) of the Dodd-Frank Act states that the provisions of the Act relating to swaps shall not apply to activities outside the United States unless those activities have "a direct and significant connection with activities in, or effect on, commerce" of the United States. We are developing a plan for application of 722(d) and are hoping to seek public input this fall. The Commission will continue to coordinate closely with the SEC and fellow regulators at home and abroad.**

2. Is derivatives regulation converging upon a single, global standard? Are Hong Kong, Singapore, the European Union and the United Kingdom pursuing derivatives regulation similar in content and scope to Title VII of the Dodd-Frank Act?

Response: **Regulators across the globe continue to work together towards achieving common goals including the G-20 agreement of September 2009 that: all standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by the end of 2012 at the latest. OTC derivative contracts should be reported to trade repositories. And non-centrally cleared contracts should be subject to higher capital requirements.**

Japan is now working to implement its reforms. In September of last year, the European Commission released its swaps proposal. The European Council and the European Parliament are now finalizing the legislation. Asian nations, as well as Canada, also are working on their reform packages.

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The swaps market is global and interconnected, which makes it imperative that the United States consult and coordinate with foreign authorities. The Commission is actively communicating internationally to promote robust and consistent standards and avoid conflicting requirements, wherever possible. The Commission participates in numerous international working groups regarding swaps, including the International Organization of Securities Commissions Task Force on OTC Derivatives, which the CFTC co-chairs. The CFTC, SEC, European Commission and European Securities Market Authority are intensifying discussions through a technical working group. The Commission also has developed a bilateral dialogue on OTC derivatives with other jurisdictions including Hong Kong, Singapore, Japan, and Canada. Discussions have focused on the details of the rules, including mandatory clearing, trading, reporting and regulation of derivatives market intermediaries. This collaboration is intended to bring consistency to oversight of the swaps markets.

3. To what extent has coordination with international regulators led to substantive changes in either CFTC regulations or regulations issued by foreign financial services regulators? Can the CFTC identify these rules?

Response: **As we do with domestic regulators, we are sharing many of our memos, term sheets and draft work product with international regulators. We have been consulting directly and sharing documentation with the European Commission, the European Central Bank, the UK Financial Services Authority, the European Securities and Markets Authority, the Japanese Financial Services authority and regulators in Canada, France, Germany and Switzerland. The Commission's rulemaking process has benefitted greatly from the feedback of foreign authorities. Ongoing consultation has contributed in particular to efforts on rulemakings regarding designated clearing organization core principles, systemically important designated clearing organizations, registration requirements for foreign boards of trade, and data recordkeeping and reporting rules.**

Cost-Benefit Analysis

1. The Dodd Frank Act imposes a regulatory structure for certain over-the-counter derivatives contracts. Considering the very tight rulemaking time frames, have you been able to include meaningful compliance cost analysis as you develop these regulations? For instance, does your analysis consider all the costs associated with these regulations, not just the immediate costs of compliance? For many asset classes, the initial start up costs will be significant. Will the implementation schedule include

adequate time for firms to develop the necessary infrastructure to comply with these new requirements?

Response: **The Commission takes very seriously the consideration of costs and benefits of the rules it considers under the Dodd-Frank Act as required under section 15(a) of the Commodity Exchange Act. The economic costs and benefits associated with regulations, especially as they pertain to commenters' concerns, are of utmost importance in the Commission's deliberation and determination of final rules.**

As noted in the guidance for cost-benefit considerations for final rules memorandum to rulemaking teams from the Chief Economist and General Counsel dated May 13, 2011, the rulemakings will involve quantified costs and benefits to the extent it is reasonably feasible and appropriate. For rules that do not have quantifiable costs, the Commission seeks to explain why such costs are not quantifiable and to explain the reasoning and supportive explanation of its predictive judgments using qualitative measures.
The Commission further recognizes the significance of meaningful issues raised by commenters regarding costs or benefits and takes those comments seriously as it is working on final rules. For those comments which persuade the Commission to modify its proposed rule, the Commission seeks to explain why the proposed alternative more effectively furthers the goals of the statute in light of the section 15(a) factors, not only in the cost-benefit section but throughout the rule's preamble. In contrast, for those comments which do not persuade the Commission to modify its proposed rule, the Commission seeks to explain its adoption of the proposed rule as the most effective means to further the goals of the statute in light of section 15(a). The Commission seriously considers commenters' concerns regarding costs or benefits and evaluates the alternatives presented.

Through the Commission's rulemaking process and its cost-benefit considerations, the agency is committed to enhancing market transparency, which will improve the integrity of the derivatives market without imposing unwarranted costs on the marketplace or financial system.

The Dodd-Frank Act provides the Commission with ample flexibility to phase in implementation of requirements. The CFTC and SEC staff held roundtables on May 2 and 3, 2011, on this issue and have solicited comments from the public regarding such concerns. This important input informs the final rulemaking process.

We've also reached out broadly on what we call "phasing of implementation," which is the timeline for rules to take effect for various market participants. This is critically important so that market participants can take the time now to plan for new oversight of this industry.

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On September 8, the Commission approved two proposed rulemakings seeking additional public comment on the implementation phasing of swap transaction compliance that will affect the broad array of market participants. The proposed rulemakings provide the public an opportunity to comment on compliance schedules applying to core areas of Dodd-Frank reform. One proposal would provide greater clarity to market participants regarding the timeframe for bringing their swap transactions into compliance with the clearing and trade execution requirements. The second proposal approved on September 8 would provide greater clarity to swap dealers and major swap participants regarding the timeframe for bringing their swap transactions into compliance with new documentation and margin rules. These proposed rules are intended to make the market more open and transparent while giving market participants adequate time to comply. Their purpose is to help facilitate an orderly transition to a new regulatory environment for swaps.

2. President Obama issued an executive order in January requiring federal agencies to conduct more rigorous cost-benefit analyses before adopting new rules. The order specifically states that agencies "should propose or adopt a regulation only upon a reasoned determination that its benefits justify its cost and to take into account benefits and costs, both quantitative and qualitative." The order also mandated agencies conduct a retrospective inquiry on all significant rulemakings adopted in the past 120 days to find ways to streamline existing regulations. In February, Cass Sunstein, Director of the OMB Office of Information and Regulatory Affairs, issued guidance asking independent agencies to comply with the executive order. Does the CFTC intend to comply with President Obama's executive order?

Response: The CFTC's practices are consistent with the executive order's principles. The CFTC conducts cost-benefit analyses in its rulemakings as prescribed by Congress in Sec. 15(a) of the CEA. The statute includes particularized factors to inform cost-benefit analyses that are specific to the markets regulated by the CFTC. Thus, we will continue to fulfill the CEA's statutory requirements.

The Commission has benefited from public comments relating to the costs and benefits of proposed rules. To further facilitate this process, the Commission approved reopening or extending the comment periods for most of our Dodd-Frank proposed rules for an additional 30 days through June 3, 2011. Commissioners and staff have met extensively with market participants and other interested members of the public about our rulemakings. CFTC staff hosted a number of public roundtables so that rules could be proposed in line with industry practices, minimizing compliance costs while fulfilling the Dodd-Frank Act's statutory requirements. Information about each of these meetings, as well as full transcripts of the roundtables, is available on the CFTC's website.

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Jeffrey A. Goldstein, Under Secretary for Domestic Finance, Treasury Department

Public Debt

1. Is the public debt of the United States a risk that merits evaluation in the annual report to Congress of the Financial Stability Oversight Council? Please explain why or why not you maintain this position.

   The U.S. fiscal situation is of critical concern to all members of the FSOC. The FSOC is charged with identifying, analyzing, and monitoring vulnerabilities in the financial system and emerging threats to maintaining stability. In preparing the FSOC's annual report, the FSOC and staff of the FSOC member agencies have considered a broad range of significant financial market developments and potential emerging threats to financial stability, including broader sovereign fiscal conditions. In particular, the U.S. fiscal situation will continue to be a focus of the FSOC member agencies as we monitor the financial system and prepare the annual report for release.

Section 113 Designations

1. How will the Council consult with home country supervisors of foreign nonbank financial companies being considered for enhanced supervision by the Federal Reserve? Has there been an open dialogue with foreign supervisors leading up to the designation of systemically important financial institutions?

   The FSOC and its members are working closely with other jurisdictions and international authorities to ensure consistent regulation and a level playing field for financial companies. The FSOC and its member agencies are working with the Financial Stability Board (FSB), the Basel Committee on Bank Supervision (BCBS), and relevant national authorities to develop both domestic and international heightened prudential standards. We will be consistent with our obligations under Dodd-Frank while striving to maintain a level playing field for U.S. firms.

2. Section 165 of the Dodd-Frank Act automatically subjects bank holding companies with at least $50 billion in assets to heightened prudential standards; that section also provides that these heightened standards must "increase in stringency" based on the risk profile of the individual bank holding company. In other words, the nature and degree of heightened supervision are supposed to be tailored to the actual risk presented by the bank holding company. What are the Treasury, FSOC, and the banking agencies doing to ensure that regulation under Section 165 will, in fact, be (i) graduated and tailored to actual risk and

(ii) coordinated with proposals from other regulatory authorities regarding the regulation of systemically important firms?

The FSOC is working with the Federal Reserve to develop a framework that adequately assesses the risk profile of bank holding companies and to set appropriate heightened prudential standards in accordance with those risks. The Council recognizes that heightened prudential standards should reflect different firms' risk profiles. The Council in its recommendations and the Federal Reserve Board, in the standards that it sets, may differentiate on either an individual or category-wide basis, taking into consideration capital structure, riskiness, complexity, financial activities, size, and other risk-related factors that the Council deems appropriate. The Council is working closely with its all of its member agencies, including the prudential regulators, throughout this process to coordinate activities.

At its June 25th meeting, the Group of Governors and Heads of Supervision (GHOS) agreed on a consultative document setting out measures for global systemically important banks. On July 18, the FSB Plenary will review and approve the consultative document, which will be released publicly at the end of July. Final recommendations are due to G-20 ministers in October and only at that time might the names of firms required to meet the surcharge be made public.

The GHOS press release included disclosure about the range of surcharges (1 percent to 2.5 percent), the composition (common equity only), transition period (2016 – end 2018) and methodology (5 broad categories). It did not provide disclosure about the scope or identity of firms subject to the surcharge.

The Federal Reserve, working with the FSOC and its member agencies, will implement the heightened prudential standards under Dodd-Frank in a manner consistent with the surcharges developed by the BCBS.

FSOC and Coordination

1. If the Chairperson of FSOC, Secretary Geithner, is a non-executive chair, what value does the FSOC regulatory structure add to promoting the consistency of rulemakings among agencies? How is FSOC's role materially different from the President's Economic Group or ordinary interagency coordination?

Dodd-Frank gives the FSOC a statutory mandate to facilitate information sharing and coordinate domestic financial services policy, rulemaking, examinations, reporting requirements, and enforcement actions across agencies and creates joint accountability for the strength of the financial system. Already, the member agencies have worked through the FSOC to develop an integrated

roadmap for Dodd-Frank implementation, to coordinate an unprecedented six-agency proposal on risk retention, and to develop unanimous support for recommendations on implementing the Volcker Rule.

The FSOC's institutional structure also helps facilitate interagency coordination. In addition to regular FSOC meetings, the deputies and other FSOC standing committees regularly meet to promote collaboration and coordination among member agencies. As Chair of the FSOC, the Secretary of the Treasury will continue to make it a top priority that the work of the regulators is well-coordinated.

2. With respect to Title VII of Dodd-Frank, the CFTC and the SEC are proposing vastly different rules for some of the exact same products. Is it not the FSOC's role to ensure coordination? Do you lack authorization to ensure coordination? Should Congress provide it?

Given the importance of Dodd-Frank implementation, independent regulators will have different views on complicated issues. Working through differences is an important part of getting the substance right. The SEC and CFTC are independent regulators who are working diligently to implement rules for much needed regulation of over the counter derivatives markets. They have engaged the public jointly through a series of roundtable discussions and continue to work together to reconcile differences in approach. As Chair of the FSOC, the Secretary of the Treasury will continue to make it a top priority that the work of the regulators is well-coordinated.

3. The Federal banking agencies, the CFTC and the SEC all have responsibility for issuing their own rules to implement the Volcker Rule. How will the Treasury, as Chairperson of the FSOC, ensure that there are no unnecessary differences across the rules of the various regulators?

Since the issuance of the FSOC's study on the Volcker Rule in January 2011, the Treasury Department has been working hard to fulfill the statutory mandate to coordinate the regulations issued under the Volcker Rule. To meet this obligation, Treasury staff has hosted meetings twice a week with the four federal banking agencies and the SEC and CFTC. These meetings have served as constructive forums for the agencies to deliberate on key aspects of the rules and ensure that the final regulations are comparable and provide for consistent application and implementation, to the extent possible.

4. As you know, the Dodd-Frank Act mandated that the SEC study and promulgate rules to harmonize the duty of care for financial professionals providing advice to retail customers. Unfortunately, the Department of Labor has also issued a proposed rulemaking to change the rules governing when a person providing

investment advice becomes a fiduciary under the Employee Retirement Income Security Act of 1974 ("ERISA"). Due to the apparent lack of coordination, the result could be an inconsistent and possibly conflicting approach implemented by the SEC and the Labor Department. Furthermore, the new business conduct standards proposed by the CFTC could result in swap participants violating ERISA when they enter into swaps with retirement plans. What is the FSOC planning to do about this inconsistency? Will it use its authority to prevent conflicting standards from disrupting the marketplace?

The FSOC's authority is to coordinate across agencies and bring joint accountability for ensuring the stability of the financial system. As Chair of the FSOC, the Secretary of the Treasury will continue to make it a top priority that the work of the regulators is well-coordinated. To date, the Administration, including the Treasury Department, the DOL, and the SEC, are working to ensure that the policy initiatives you describe, if adopted, are consistent and not unduly burdensome. Currently, DOL's initiative is in the form of a notice of proposed rulemaking, and the final rule may differ from the version as proposed.

The SEC's initiative is in the form of a staff study that was required by the Dodd-Frank Act. The study recommends that the Commission consider rulemaking, but the Commission has not issued a rule proposal. If the Commission does issue a rule proposal, there will be an opportunity for public comment. As noted in the SEC study, the protections provided to benefit plans, participants, and retirees under ERISA have historically been different from the fiduciary protections provided to investors under the U.S. securities laws.

Further, in an open letter dated April 28, 2011 from DOL to the CFTC, DOL advised that it believes its proposed rule does not conflict with the CFTC's new business conduct standards. The letter states: "In DOL's view, a swap dealer or major swap participant that is acting as a plan's counterparty in an arm's length bilateral transaction with a plan represented by a knowledgeable independent fiduciary would not fail to meet the terms of the counterparty exception solely because it complied with the business conduct standards set forth in the CFTC's proposed regulation."

FSOC and Global Competitiveness

1. It is critical for the continued competiveness of the U.S. markets that regulatory arbitrage does not develop among markets in Europe and Asia over U.S. markets. Will the Secretary of the Treasury, as Chair of FSOC, commit to ensure that the timing of the finalization and implementation of rulemaking under Dodd-Frank does not impair the competitiveness of U.S. markets? Can you give any examples to date?

The Department of the Treasury strives to ensure a level playing field internationally and discusses market access barriers in its regular dialogues with foreign counterparts. The Department of the Treasury works closely with foreign finance ministers and regulators as well as international fora, such as the Financial Stability Board, the International Organization of Securities Commissions, and the Basel Committee on Banking Supervision, to closely coordinate in developing comparable rules and ensure that the regulatory frameworks promote the competitiveness of U.S. firms. Of course, Dodd-Frank mandates that we simultaneously address the gaps and weaknesses in regulation that allowed the recent financial crisis to occur.

2. How will FSOC ensure that U.S. firms will have equal access to foreign capital markets as foreign firms will have to U.S. markets?

The Secretary of the Treasury, as the Chair of the FSOC, strives to ensure a level playing field among markets and discusses barriers to access in regular dialogues with foreign counterparts. We have worked to reflect the fundamental principles underlying the Dodd-Frank Act in G-20 and Financial Stability Board (FSB) recommendations, as well as implementation by national authorities in the legislation and regulations of major financial jurisdictions. We have intensified international coordination to help ensure that efforts to promote safety and soundness in one major financial jurisdiction are not undermined by another, that globally active institutions are overseen by globally coordinated authorities, and that the playing field is level. Currently, we are working closely with our counterparts around the globe, including through bilateral financial dialogues with the European Commission, Japan, China, India, Singapore, and Canada.

While we hope that other countries will follow our example – and we will continue working to ensure that they do – ultimately we are undertaking financial regulatory reform because it will result in financial markets that are stronger, more resilient, and more competitive. Better regulation will not drive participants away; to the contrary, stronger, safer U.S. markets will attract participants.

3. To your knowledge, has any nation other than the United States adopted a rule like the Volcker Rule? In its capacity as coordinator of the final rules that implement the Volcker Rule, how will the Treasury Secretary, as Chairperson of the FSOC, ensure that those rules do not place the United States at a competitive disadvantage?

A number of other countries are considering instituting wide-ranging reforms; for instance, Britain's Independent Commission on Banking, the "Vickers Commission," recommends an alternative to a general prohibition on proprietary trading that they judge to be more appropriate for the British banking system.

Other countries may take different approaches to constrain excessive risk taking by their banking institutions, appropriate to the particulars of their own institutional structures. Additionally, a number of Asian countries have clear distinctions between commercial banking and investment banking.

The Department of the Treasury and the rulemaking agencies are continuing to consider the competitive implications of the Volcker Rule and working to ensure a level playing field internationally. The Treasury Department has worked diligently to fulfill its statutorily defined role as coordinator in the rulemaking process so that issues like these are appropriately considered and discussed by the rulemaking agencies.

4. Is there potential for the Volcker provisions in Section 619 to cause less regulated, "shadow banking system" participants to become primary providers of market liquidity? Are the FSOC or the agencies prepared to address this as a potential market or systemic risk if significant liquidity in U.S. markets is diverted either to less regulated entities or to non-U.S. markets?

In January 2011, the FSOC published a study on the Volcker Rule that found that the rule's implementation should strengthen American banking entities, as they would no longer be engaged in certain non-core activities that are not related to serving customers. Consistent with the study, the rulemaking agencies are working to ensure that permitted activities, such as market-making and other important forms of financial intermediation, are protected in the implementation of the statute. Protecting these vital activities is necessary to support liquidity in markets and a strong, competitive economy. The FSOC study considered ways to design a regulatory framework that will effectively enforce the statute while protecting well-functioning markets and reducing regulatory burden and cost.

The clearly identifiable proprietary trading that banking entities engaged in prior to enactment of the Volcker Rule was small relative to their market-making operations and provided a relatively nominal amount of liquidity to the markets. Prohibiting this impermissible activity should not prevent banking entities from engaging in important customer driven, market-making activity.

FSOC member agencies believe that the provision of liquidity to the system is an important function to safeguard. To support the FSOC's role in monitoring, identifying and analyzing risk, agencies will employ a number of new tools provided by Dodd-Frank that promote greater transparency for the market-making function including data repositories for all derivatives transactions and private fund registration and reporting.

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5. Section 619 of Dodd-Frank establishes a 10% concentration limit for U.S. firms and foreign firms with U.S. operations. When calculating total liabilities, foreign firms are only required to include U.S. operations while U.S. firms must include total global liabilities. How will the FSOC address this disparate treatment of U.S. firms?

   The concentration limit, as enacted in Dodd-Frank, treats acquisitions by U.S-based firms and foreign-based firms differently. The statutory concentration limit applies to the global consolidated liabilities of U.S. financial companies but only to the liabilities of the U.S. operations of foreign firms. As a result, a large, globally active U.S. financial company could be prevented from making any material acquisitions (U.S. or foreign), but a large foreign financial company with a relatively small U.S. presence may be able to acquire a U.S. or foreign financial company, because only the U.S. liabilities of the resulting company would be subject to the concentration limit.

   In addition, depending on the extent of its U.S. operations, the foreign-based company might be able to continue to acquire U.S. financial companies without running afoul of the concentration limit because, unlike a U.S.-based firm, the foreign operations of the foreign-based company are excluded from the concentration limit formula. Over time, this disparity could increase the degree to which the largest firms operating in the U.S. financial sector are foreign-based.

   Further consideration and review of this issue is warranted, and the FSOC recommended in its January 2011 study on concentration limits that the Federal Reserve continue to monitor and report on these competitive dynamics. If the FSOC determines that there are any significant negative effects, the FSOC will then issue a recommendation to Congress to address adverse competitive dynamics.

6. As you know, Dodd-Frank directs the Federal Reserve to impose "more stringent" prudential standards with respect to systemically important bank holding companies and designated nonbank financial companies. Similarly, the Financial Stability Board and the Basel Committee have proposed that global systemically important financial institutions be subject to heightened requirements above and beyond those imposed on other firms. What work has the Treasury Secretary done to ensure that the heightened standards imposed under Basel III are developed and implemented in a manner that is consistent with those imposed under Dodd-Frank? How will the Treasury Department ensure harmonization of these regulatory regimes and avoid any potential damage to the competitiveness of U.S. firms vis-à-vis foreign firms?

   The FSOC and its members are working closely with other jurisdictions and international authorities to ensure consistent regulation and a level playing field

for financial companies. The FSOC and its member agencies are working with the Financial Stability Board (FSB), the Basel Committee on Bank Supervision (BCBS), and relevant national authorities to develop both domestic and international prudential standards. There are ongoing discussions in the FSB and the BCBS to develop methodologies to determine globally systemically important banks (G-SIBs). The United States—through the Treasury Department, the U.S. banking regulatory agencies, and the Securities and Exchange Commission—participates in these discussions. This summer, the BCBS is scheduled to release for public consultation a recommended methodology for identifying G-SIBs. Following public consultations, in the fall of 2011, the FSB will make its recommendations to the G-20 leaders on systemically important financial institutions.

FSOC and Insurance Expertise

1. One key position on the Council remains unfilled: a voting member who has insurance expertise. When will this vacancy be filled? Is it appropriate to proceed with Section 113 designations without the benefit of the input of all voting and nonvoting members?

   Congress created FSOC to identify and address systemic risk to US financial stability. One of the tools provided by Congress is designation for heightened supervision by the Federal Reserve under Section 113 of the Dodd-Frank Act. This is intended to ensure that those financial companies whose failure could pose a risk to US financial stability are subject to heightened capital requirements and prudential supervision. Such nonbank financial companies may include insurance companies.

   On June 27, 2011, the President nominated Mr. Roy Woodall as the independent member of the FSOC. Mr. Woodall brings extensive experience and insurance expertise to the FSOC. He served as the Senior Insurance Policy Analyst at the Department of the Treasury from 2002 to 2011, and has served as President of the National Association of Life Companies and former Commissioner of Insurance for the Commonwealth of Kentucky over the span of his distinguished career.

   The FSOC also benefits from the service of Mr. John Huff, the Director of the Missouri Department of Insurance, Financial Institutions and Professional Registration, who was selected as a member by the state insurance commissioners. Mr. Huff offers a breadth of knowledge and the important perspective of the primary functional insurance regulators.

   Secretary Geithner has appointed Mr. Michael McRaith as the director of the Federal Insurance Office. Prior to assuming this position, Mr. McRaith was the

director of the Illinois Department of Insurance. He brings significant experience and judgment to the FIO and to the FSOC as a non-voting member.

The FSOC is progressing in a prudent and informed way in all decision making, and is relying on the considerable expertise among its members to ensure that it benefits from a wide variety of views.

2. Director John Huff sent a letter to Treasury Secretary Geithner dated February 9, 2011 discussing his frustrations with his ability to meaningfully participate in FSOC's work. Director Huff also made a request for additional resources for staffing that would be at no additional cost to the taxpayers. Undersecretary Goldstein, what steps has the FSOC taken since the hearing to allow John Huff, a nonvoting FSOC member with insurance expertise, to utilize resources provided by the National Association of Insurance Commissioners (NAIC) staff?

We share your interest in ensuring that all FSOC members can participate fully in the work of the FSOC. The Dodd-Frank Act gives FSOC members, including the state bank, securities, and insurance regulator members, the flexibility to lean on the resources available in their own agency. For Mr. Huff, this would include the staff of the Missouri Department of Insurance, Financial Institutions and Professional Registration.

In addition to his own departmental staff, Mr. Huff has asked for additional resources. To accommodate his needs, additional staff are now supporting Mr. Huff in his work on the Council, and they are subject to the Council's confidentiality agreements. The FSOC has endeavored to balance Mr. Huff's requests for support with the need to maintain adequate confidentiality protections given the sensitive nature of the FSOC's work and its access to confidential supervisory information.

The statute requires that all members (and member agencies) maintain the confidentiality of FSOC data, information and reports. Mr. Huff, as a member of the Council, is a party to FSOC's information sharing protocol. Beyond those restrictions which apply to all members, Mr. Huff is free to consult with whomever he chooses to make informed decisions, including other state insurance regulators or staff of their association.

John Huff, Director, Missouri Department of Insurance, Financial Institutions, and Professional Registration (designated state insurance commissioner)

1. Director Huff, at the hearing Treasury Undersecretary Jeffrey Goldstein stated, "We will continue to work with Mr. Huff to make sure that he has appropriate support." Since the hearing what has the Treasury done to ensure that you are permitted to receive assistance from both individual state insurance commissioners and the National Association of Insurance Commissioners (NAIC)? Since the hearing, the Department of the Treasury has announced the creation of a Federal Advisory Committee on Insurance. Will this Committee change or improve the conditions under which you provide your FSOC duties?

    - At this point, I am still unable to consult with my fellow insurance regulators regarding confidential regulatory matters relating to insurance that are discussed in FSOC proceedings or in its various committees. With respect to the Federal Advisory Committee on Insurance, my understanding is that it is an advisory committee to the Federal Insurance Office on insurance issues. It has no relevance to my ability to represent my fellow regulators on FSOC. While I would defer to the Treasury Department regarding the specifics of this committee, to my knowledge, members of that panel will not have access to any confidential information or discussions occurring at FSOC relating to insurance, as the group will reportedly include industry and consumer participants.

2. There is no voting member on FSOC with insurance expertise and one of the non-voting members with insurance expertise, the Director of the Federal Insurance Office, was just nominated in March. Do you believe the Council should delay publication of the final rule on systemically significant designation until after all the Council's vacancies are filled and the new members have had an opportunity to provide their valuable insights and input on that rule?

    - I believe it behooves the FSOC to have the benefit of the expertise of all of its members before making decisions on designation criteria and ultimately, designations.

3. Director Huff, your fellow state regulators are involved in international efforts to develop approaches to determine whether specific insurers are globally systemically important. However currently, you are prevented from consulting with your fellow state regulators on the domestic work you are conducting in this arena through FSOC. Are you concerned that there may be inconsistent approaches to systemic risk being developed at home and abroad?

    - As I indicated in my testimony, the NAIC and the state regulators are heavily involved in the International Association of Insurance Supervisors (the international standard setting body for insurance regulators), which, is developing initial approaches for evaluating and determining global systemically important insurers at the request of the Financial Stability Board (FSB). As indicated in your question, while regulators are able to consult with each other on these international efforts, I cannot consult with my fellow regulators regarding confidential discussions taking

place at FSOC relating to the process for designation of SIFI's. With that said, my fellow state regulators and I are doing the best we can despite the restrictions.

Questions for The Honorable J. Nellie Liang, Director, Office of Financial Stability Policy and Research, Board of Governors of the Federal Reserve System, from Chairman Neugebauer:

Federal Reserve and Section 113 Determinations

1. In a recent speech, Federal Reserve Board Governor Daniel Tarullo said that the list of nonbank financial companies that would be deemed systemically significant will be short, and that the standard for designation set by Congress "should be quite high." Do you agree with this position? What is the danger of including many firms in the systemically significant category?

I believe that the FSOC should designate any nonbank financial company whose material financial distress or failure would pose a serious threat to financial stability. Whether a firm meets this standard inevitably involves a judgment on how its distress would be transmitted to the broader financial system and real economy. The FSOC is still developing its analytical framework and proposed rule for the designation process, and so it is too soon to know how many nonbank financial firms the FSOC will designate as systemically important. Firms that are designated will be subject to enhanced prudential standards, such as capital, leverage, and liquidity, and supervision by the Federal Reserve. Imposing new standards on firms that do not pose a systemic risk could require firms to adjust their business practices and raise costs unnecessarily, which would restrict credit and other financial intermediation services. In addition, designating firms that do not pose a systemic risk would stretch and divert limited energies and resources of regulators from the firms that require greater supervisory attention.

2. Could you describe the link between moral hazard and designations of nonbank financial institutions as systemically significant? Is the Federal Reserve concerned that designated firms will enjoy a lower cost of funding and other privileges because a designation appears to confer "too big to fail" status?

Designation itself is unlikely to create moral hazard; moral hazard prevails when nonbank financial firms expect government support in times of distress because of the serious threat their failure would have on overall financial stability, independent of designation. Indeed, most firms appear to be vigorously seeking to avoid designation. The intent and effect of the designation process and the accompanying enhanced regulatory standards in the Dodd-Frank Act is to reduce the systemic risk posed by these firms and reduce their ability to take on excess risk or expect government support. Under the Dodd-Frank Act, designated institutions will be subject to prudential standards that will include, among other requirements, enhanced risk-based capital and leverage requirements, liquidity requirements, and single-counterparty credit limits. The firms will also be required to submit recovery and resolution plans, to facilitate an orderly resolution process if necessary.

Global Competitiveness

1. Is there potential for the Volcker provisions in Section 619 to cause less regulated, "shadow banking system" participants to become primary providers of market liquidity?

Are the FSOC or the agencies prepared to address this as a potential market or systemic risk if significant liquidity in U.S. markets is diverted either to less regulated entities or to non-U.S. markets?

It is reasonable to expect that some portion of the activities that will be prohibited by the Volcker provisions in Section 619 to migrate from more regulated banking institutions to less regulated hedge funds or other non-bank institutions. Since most of these non-bank institutions are much smaller and less complex than the firms affected by Section 619, any risks created by their participation in providing market liquidity through proprietary investments or trading are much less likely to present a serious threat to financial stability in the event of a failure of any one firm. However, the Board and the Council will continue to monitor the systemic risk presented by these firms and will be prepared to take action through a variety of tools if the risk presented in aggregate becomes a serious threat to financial stability.

2. Will the Federal Reserve Board conduct an impact study to understand whether the implementation of the Volcker and Concentration Limit rules will cause U.S. markets to lose liquidity or place U.S. markets or institutions at a competitive disadvantage in relation to foreign markets and institutions?

The Board recognizes the importance of limiting the unintended consequences of these rules on the competitiveness of U.S. markets, and will review and monitor any impact that implementation has in potentially creating competitive disadvantages for U.S. firms in relation to foreign markets and institutions. As a member of the FSOC, the Board will encourage the Council to fully consider the impact of the timing and substance that related rulemaking has on the competitiveness of U.S. markets, and seek to mitigate that impact wherever feasible. In addition, the Board (together with other U.S. government regulatory agencies) has been working to preserve a level playing field that will continue to allow U.S. companies to compete effectively and fairly in the global economy through ongoing discussions with foreign supervisory authorities on possible changes to bank capital standards and other international rules affecting financial markets and firms.

Coordination with FSOC

1. The Dodd-Frank Act created the Office of Financial Research to serve the FSOC by collecting requisite data from affected entities and assessing certain firms to pay for its and the FSOC's work. Why is there a need for an "Office of Financial Stability Policy and Research" within the Federal Reserve? How will this be funded? Has the Fed made projections of the costs associated with this new Office, which, I might add, is not mandated by the Dodd-Frank Act?

The Office of Financial Stability Policy and Research (OFSPR) does not serve the same role as the OFR; rather, it was created to better coordinate and support the continuing efforts of the Federal Reserve Board in promoting financial stability. It contributes to the Federal Reserve System's multidisciplinary approach to the supervision of large, complex institutions, in

supporting the Board's independent responsibilities to evaluate and mitigate risks to the financial system and banking sectors, and in supporting the Chairman's participation in the FSOC. Further, OFSPR is principally staffed by economists that are rotating through from other divisions of the Board and does not represent a substantial increase in costs.

2. Section 165 requires the firms that the Council has designated as "too big to fail" to file resolution plans with the Federal Reserve that demonstrate that these firms can be resolved quickly and in an orderly fashion, presumably for the purpose of showing that these firms are not, in fact, "too big to fail." Will these plans be made public? If not, why would these firms' creditors or the markets have any reason to think that these plans were credible, and that creditors' recoveries would be limited to the assets of the failed firm?

The proposed regulation implementing the resolution plan requirement calls for the submission of details regarding Covered Companies that are publicly available or otherwise are not sensitive and could therefore be made public, as well as sensitive confidential information. The Dodd-Frank Act directs the Federal Reserve and the FDIC to maintain the confidentiality of any non-publicly available information submitted as part of a resolution plan. This is the type of information that Covered Companies would not customarily make available to the public and that a Covered Company's primary federal regulator typically would have access to and could review as part of the supervisory process in assessing the overall condition, safety and soundness of, and compliance with applicable laws and regulation by a Covered Company. Public disclosure of the sensitive supervisory and proprietary information contained in these resolution plans would place these firms at a competitive disadvantage and could discourage the firms from being as candid and complete as possible in their submissions.

The Federal Reserve and the FDIC are working to determine what portions of a resolution plan may be publicly disclosed without revealing sensitive supervisory, propriety, or competitive information contained in the plans.

Tim Long, Chief National Bank Examiner and Senior Deputy Comptroller for Regulatory Policy, Office of the Comptroller of the Currency (OCC)

CFPB and Prudential Regulators

The Dodd-Frank statute requires a 2/3 vote of the ten voting members of the Council to over-ride rules issued by the Consumer Financial Protection which jeopardize the stability of the entire financial system. Do you believe this threshold is too high? What would be a more reasonable standard?

The OCC believes it is critical that rules and supervisory determinations of the Bureau be balanced so as not to have a negative impact on the safety and soundness of depository institutions. However, the Dodd-Frank Act raises a variety of issues for the agencies to resolve in this regard.

Under the Dodd-Frank Act, the Bureau is required to consult with prudential regulators before issuing a proposed rule and during the comment period, before a final rule is issued. However, the Bureau is not required to take the concerns of bank regulators into account during the consultation process. And if a prudential regulator objects to a CFPB rule in writing, the Bureau must only include a description of the objection in the adopting release and the basis for the Bureau's decision regarding the objection.

In addition, while a member agency can petition the FSOC to set aside all or part of a Bureau regulation, the FSOC may do so only if the rule would put the whole banking system or the stability of the financial sector at risk – which is a very high bar.

A bank could also become subject to conflicting supervisory determinations by its prudential regulator and the Bureau. The Dodd-Frank Act framework designed to address such conflicts is cumbersome and has the potential to put our supervisory actions on hold during this resolution process.

However, the OCC hopes to establish a cooperative and productive relationship with the Bureau under the current framework provided by Congress, to minimize the potential for conflicts and obviate the need to petition the FSOC for relief.

Global Competitiveness

The final rules that implement the Volcker Rule are due to be published this October. Presumably, draft rules will be issued fairly shortly. Given this extremely tight timeline, how has the Chairman of the FSOC, in its capacity as coordinator of the final rules that implement the Volcker Rule, worked with your agency to ensure that public comments are taken fully into account in the final rules?

In its coordinating role, Treasury (together with the various agencies implementing the Volcker provisions of the Dodd-Frank Act), has developed a timeline that would ensure that public comments are taken fully into account in the final rules. The agencies have been working hard to

meet the individual milestones in this timeline so that a final rule can be published by October. However, the Volcker provisions raise many complex issues that must be resolved on an interagency basis, and meeting this statutory deadline will be a challenge. It is my view that we should not favor speed over a more robust process designed to ensure that we get this rule right. The OCC recognizes that we must balance the requirement that we meet applicable statutory deadlines with the need to provide a comment period that allows the public sufficient time to contribute meaningful comments, and the agencies adequate time to consider the comments received.

Response to questions from the Honorable Randy Neugebauer
by Art Murton, Director of Insurance and Research,
Federal Deposit Insurance Corporation

Q1: The Federal Deposit Insurance Corporation – and others – claim that 'resolution authority' is an alternative to bailouts. Yet the 'resolution authority' grants the FDIC the authority to borrow up to the full value of a failing firm's assets, to pay creditors up to the face value of their claims, and then try to claw back any overpayments from those creditors. Please explain how these activities do not constitute a bailout.

A1: Title II of the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (Dodd-Frank Act) prohibits taxpayer bailouts through a variety of legislative initiatives. The Title specifically establishes the following rules and processes for preventing taxpayer bailouts:

- Establishes clear statutory rules:
    - requiring the liquidation of failing financial companies that pose a significant risk to the financial stability of the United States;
    - expressly prohibiting the use of taxpayer funds to prevent the liquidation of any financial company under Title II; and
    - specifically barring taxpayers from bearing any losses from the FDIC's exercise of Title II authority.

- Establishes a funding mechanism that ensures that losses will be borne by creditors and shareholders of the failed financial company for which a systemic determination has been made (the "covered financial company" or CFC) and requires that any shortfall will be made up by a designated segment of the financial industry.
    - The FDIC may borrow from the Treasury Department (Treasury) up to the statutory Maximum Obligation Limitation (MOL) monies to fund the operations of the receivership and/or any bridge financial company established by the FDIC as part of the orderly liquidation process.
    - The MOL is calculated based on a statutory formula. In sum, the aggregate amount of outstanding obligations in connection with a Title II resolution cannot exceed (1) 10 percent of the CFC's total consolidated assets, based on the most recent financial statement available, for the first 30 days following the FDIC's appointment as receiver (or a shorter time period if the FDIC has calculated the amount described in (2) below), and (2) 90 percent of the fair value of the CFC's total consolidated assets that are available for repayment. The statute requires the FDIC and the Treasury (in consultation with the Financial Stability Oversight Council (FSOC)) to issue joint regulations governing the calculation of the MOL.
    - If these assets are insufficient to repay Treasury borrowings, the FDIC is required to "clawback" payments made to certain creditors in excess of payments made to similarly situated creditors (except where the payments covered operations essential to the operations of the receivership or bridge financial company).

- If this "clawback" is insufficient to pay unmet obligations to Treasury, the FDIC is required to charge risk-based assessments on "eligible financial companies" (bank holding companies with total consolidated assets of $50 billion or more and any nonbank financial company supervised by the Federal Reserve Board pursuant to Title I of the Dodd-Frank Act) and financial companies with total consolidated assets of $50 billion or more that are not "eligible financial companies."

- Ensures that shareholders receive no payments until all other claims are paid (including the FDIC and other government entities), and that creditors and shareholders bear the loss of the failure.

  - A priority scheme establishes the order in which claimants will receive payment on some percentage of their claims, depending on the value of the CFC's liquidated assets. All similarly situated creditors will be treated in the same manner (that is, will be paid the same percentage of their claim as others in the same position) with the *limited exception* that an additional payment to a particular creditor is permissible *if* making that additional payment will enable the receiver to maximize the return on the assets of the CFC and minimize losses. *See* Sections 210(b)(4), (d)(4) and (h)(5)(E). Should proceeds from asset disposition be insufficient to repay Treasury borrowings, these additional payments will be reclaimed, unless they were essential to the operations of the receivership or bridge financial company.

Q2: Section 165 requires the firms that the Council has designated as "too big to fail" to file resolution plans with the Federal Reserve that demonstrate that these firms can be resolved quickly and in an orderly fashion, presumably for the purpose of showing that these firms are not, in fact, "too big to fail." Will these plans be made public? If not, why would these firms' creditors or the markets have any reason to think that these plans were credible, and that creditors' recoveries would be limited to the assets of the failed firm?

A2: The Dodd-Frank Act requires the FSOC to identify those nonbank financial companies that should be subject to heightened prudential supervision by the Federal Reserve Board. These companies are referred to as systemically important financial institutions, or "SIFIs." These companies and bank holding companies that have $50 billion or more in total consolidated assets will be required to submit resolution plans.

The FDIC views the resolution plan requirement under Title I as a key component of the Dodd-Frank Act, and as an integral part of the infrastructure established by the Act to end "too-big-to-fail." The FDIC and the Federal Reserve Board have issued a Notice of Proposed Rulemaking (NPR) on resolution plans and credit exposure reports for comment (the comment period ends on June 10, 2011). As part of that rulemaking, the agencies are working diligently to develop a thoughtful and substantive process for reviewing resolution plans to determine whether a plan is both credible and would facilitate an orderly resolution of the company under the Bankruptcy Code. If, after two years and the imposition of more stringent standards, the resolution plan still

does not meet the statutory standards, the FDIC and the Federal Reserve Board may, in consultation with the FSOC, direct a company to divest certain assets or operations.

Confidential business information and confidential supervisory information submitted by financial companies as part of their resolution plans will remain confidential. Those companies, however, will continue to be required to comply with other applicable laws, such as the securities laws, which require certain public disclosures. Section 165 of the Dodd-Frank Act charges the FDIC and the Federal Reserve Board with determining whether the plans are credible and would facilitate an orderly resolution in bankruptcy.

A firm's creditors and the market at large will continue to evaluate these entities based on their public disclosures and their business practices as before. However, the statutory requirement for resolution plans and the authority to undertake an orderly liquidation under Title II (if a systemic determination is made, including a finding that resolution under bankruptcy would have serious adverse effects on financial stability) should make it clear to market participants that all financial companies that fail will be resolved, not bailed out. Further, as described in the response to question 1, Title II clearly establishes that creditors and shareholders can expect to bear losses from that failure.

Q3: What would the FDIC have required from AIG, Lehman Brothers or Bear Stearns in the way of 'living wills'? How would living wills have helped as the firms collapsed? If an institution is insolvent, and the taxpayer is making up the difference, what magic does a 'living will' create?

A3: The SIFI designation process is not yet complete, so no specific companies have yet been designated. Nevertheless, assuming the Dodd-Frank Act had been in place before the financial crisis, and the companies named in this question had been designated as SIFIs, under the NPR issued jointly by the Federal Reserve Board and the FDIC, each resolution plan, or "living will," is required to contain:

- a strategic analysis that should demonstrate the specific actions a covered company would take to facilitate an orderly resolution in an environment of material financial distress;
- information regarding the covered company's overall organizational structure and a description of interconnections and interdependencies among the covered company and its various subsidiaries and other legal entities;
- a strategy for maintaining and funding critical operations and core business lines, mapped to legal entities;
- information regarding the material assets, liabilities, derivatives, hedges, capital, and funding sources of the covered company;
- a description of trading, payment, clearing, and settlement systems utilized by the covered company;
- a strategy for ensuring that any insured depository institution subsidiary will be adequately protected from risks arising from the activities of nonbank subsidiaries of the covered company;

- for a covered company with foreign operations, the plan must identify the extent of the risks related to those operations and the covered company's strategy for addressing such risks;
- information regarding the covered company's management information systems; and
- a description of the covered company's processes and systems to collect, maintain, and report the information and other data underlying the resolution plan.

When the recent crisis occurred, the lack of information about operations of problem firms and limited regulatory options for responding to distress in large, non-bank financial companies left policymakers with a highly unfavorable tradeoff of either propping up failing institutions with expensive bailouts or allowing destabilizing liquidations through the normal bankruptcy process. The companies named in this question (and many others currently) maintained numerous subsidiaries that managed their activities within business lines that crossed many different organizational structures and regulatory jurisdictions. This can make it very difficult to implement an orderly resolution of one part of the company without triggering a costly collapse of the entire company that can spill over into the broader financial system. Indeed, the bankruptcy of Lehman Brothers Holdings Inc. (Lehman) in September 2008 exacerbated the liquidity crisis at AIG and other institutions freezing our system of intercompany finance and made the 2007-2009 recession the most severe since the 1930s.

The resolution planning process is intended to eliminate the destabilizing effects related to failures of large and complex financial institutions by allowing regulators and firm managers to plan in advance of financial firms' problems. The Dodd-Frank Act requires firms designated as SIFIs to maintain satisfactory resolution plans that demonstrate their resolvability in a crisis. The larger, more complex, and more interconnected a financial company is, the longer it takes to assemble a full and accurate picture of its operations and develop a viable strategy for its resolution. By requiring detailed resolution plans in advance, and authorizing an on-site FDIC team to conduct pre-resolution planning for the companies named in this question, the SIFI resolution framework would have filled in the informational gaps that were lacking during the crisis.

The FDIC recently released a report detailing how the filing of resolution plans, the ability to conduct advance planning, and other elements of the resolution planning process could have dramatically changed the outcome if they had been available in the case of Lehman. The report concludes that, due to the powers to preserve valuable assets and operations in the Dodd-Frank Act, the FDIC liquidation of Lehman would recover substantially more for creditors than the bankruptcy proceedings -- and at no cost to taxpayers.[1]

Regarding the ability of living wills to offset a situation where "...an institution is insolvent, and the taxpayer is making up the difference...," it is important to reiterate that taxpayers will not be required to be responsible for any losses associated with a resolution of a SIFI. As mentioned in the response to question 1, Title II of the Dodd-Frank Act specifically bars the taxpayers from absorbing any of the losses from a resolution. Rather, all of the losses must be borne by the creditors and shareholders. If that is insufficient, losses are absorbed through a "clawback" of

[1] "The Orderly Liquidation of Lehman Brothers Holdings under the Dodd-Frank Act," *FDIC Quarterly*, Vol. 5, No. 2, 2011. http://www.fdic.gov/regulations/reform/lehman.html

any amounts paid to certain creditors, and if those sources are insufficient, through an assessment against the industry.

Q4. A senior Federal Reserve regulator has been quoted as saying: "Citibank is a $1.8 trillion company, in 171 countries with 550 clearance and settlement systems. We think we're going to effectively resolve that using Dodd-Frank? Good luck!" Before receiving "living will" resolution plans from firms, will the FDIC independently evaluate how it would resolve a large multinational bank with numerous business lines like Citigroup? Does the agency know how much such a resolution would cost? Please provide any staff work product on this topic.

A4: The FDIC does not comment on open institutions or estimate costs of resolutions that have not occurred. Primary regulators of large banks and bank holding companies already have the ability to review operational structures as part of the supervisory process. The Dodd-Frank Act also authorizes the FDIC and Federal Reserve Board to require, if necessary, changes in the structure of activities to ensure that they meet the standard of being resolvable in a crisis. The FDIC believes the ultimate effectiveness of the SIFI resolution framework will depend in large part on the willingness of the FDIC and the Federal Reserve Board to actively use this authority to require organizational changes that promote the ability to resolve SIFIs and large bank holding companies using the Bankruptcy Code if possible.

To focus on our expanded responsibilities to monitor and, potentially, resolve SIFIs and large bank holding companies, we established the Office of Complex Financial Institutions (OCFI). The OCFI will be responsible for the FDIC's role in the oversight of bank holding companies with more than $100 billion in assets and their corresponding insured depository institutions as well as for non-bank SIFIs. The OCFI, in concert with their counterparts at the Federal Reserve Board, also will be responsible for reviewing resolution plans and credit exposure reports developed by the SIFIs and large bank holding companies. Additionally, the OCFI will be responsible for implementing and administering the FDIC's SIFI resolution authority and for conducting special examinations on SIFIs under the FDIC's backup examination and enforcement authority.

FDIC and Section 113 Determinations

Q5: Recent speeches and press reports indicate that the FDIC is at odds with the Federal Reserve regarding the number of nonbank financial institutions that should be subject to enhanced supervision. Why does the FDIC believe that the list of firms designated should be larger?

A5: The process of designating which SIFIs will be subject to heightened supervision by the Federal Reserve Board under Title I of the Dodd-Frank Act is not yet complete. Therefore, it is still uncertain how many firms will receive a SIFI designation. The FDIC is working closely with all of the FSOC agencies, including the Federal Reserve Board, to implement the SIFI designation process and to ultimately designate the appropriate number of firms.

The FSOC issued an Advanced Notice of Public Rulemaking (ANPR) last October and an NPR on January 26, 2011, describing the processes and procedures that will inform the FSOC's designation of SIFIs under the Dodd-Frank Act. Concerns have been raised about the lack of detail and clarity regarding the designation process in the ANPR and NPR. The FDIC agrees that it is important that the FSOC move forward and develop some hard metrics to guide the SIFI designation process. The FSOC is in the process of developing further clarification of the metrics for comment that will provide more specificity as to the measures and approaches being considered.

In determining the appropriate way to designate SIFIs, the FDIC is focused on getting the metrics right rather than identifying a specific number of firms for designation. Importantly, the FDIC believes that the ability of an institution to be resolved in bankruptcy without systemic impact should be a key consideration in the SIFI designation process. Further, the FDIC believes that the concept of resolvability is consistent with several of the statutory factors that the FSOC is required to consider in designating a firm as systemic; that is, size, interconnectedness, lack of substitutes, and leverage. If an institution can reliably be deemed resolvable in bankruptcy by the regulators, and operates within the confines of the leverage requirements established by bank regulators, then it should not be designated as a SIFI.

Global Competitiveness

Q6: The final rules that implement the Volcker Rule are due to be published this October. Presumably, draft rules will be issued fairly shortly. Given this extremely tight timeline, how has the Chairman of the FSOC, in its capacity as coordinator of the final rules that implement the Volcker Rule, worked with your agency to ensure that public comments are taken fully into account in the final rules?

A6: The financial reforms required by the Volcker Rule are critical for the long-term stability of the financial industry. However, the agencies realize that balanced regulation is needed to avoid excessive burden and adverse consequences to important financial intermediation activities. To ensure that the Volcker Rule maintains the fine line between eliminating proprietary trading and leaving intact important market-making functions, the agencies have fully considered the public comments received on the Volcker Rule study and will continue to carefully consider all of the public comments that may be received throughout the rulemaking process. As noted, the Dodd-Frank Act requires the Chairman of the FSOC to coordinate the issuance of regulations to implement the Volcker Rule. Thus, while not a party to the resulting regulations, Treasury staff, as a representative of the Chairman of the FSOC, is serving an important role in the rulemaking process by facilitating interagency discussion and ensuring that the agencies carefully consider public comments during the deliberation process.

Speech

55 KB PDF

Governor Daniel K. Tarullo

At the 2011 Credit Markets Symposium, Charlotte, North Carolina

March 31, 2011

Regulating Systemic Risk

Events of the last few years have given the phrases "systemic risk" and "financial stability" a prominent place in the lexicon of policymakers. Although protecting financial stability is germane to numerous areas, including monetary policy, today I will focus on some aspects of its relevance for financial regulation. More specifically, I will address the implementation of the new statutory regime for special supervision and regulation of financial institutions whose stress or failure could pose a risk to financial stability. Then I will identify two important issues raised by the implementation of this regime that need the attention of academics, analysts, and policymakers if we are to regulate systemic risk effectively and efficiently.[1]

Distressed Firms and Systemic Risk

Let me start by detailing how distress in a financial firm can create risks to overall financial stability, as a prelude to suggesting how an understanding of those dynamics should inform prudential regulatory policies. There are basically four ways:

- *First* is the classic domino effect, whereby counterparties of a failing firm are placed under severe strain when the firm does not meet its financial obligations to them. Their resulting inability to meet their own obligations leads, in turn, to severe strains at their other significant counterparties, and so on through the financial system.
- *Second* is a fire-sale effect in asset markets, when a failing firm engages in distress sales in an effort to obtain needed liquidity. The sudden increase in market supply of the assets drives down prices, often substantially. As we saw in the recent crisis, this effect transmits not only to firms that must sell assets to meet immediate liquidity needs but, because of margin calls and mark-to-market accounting requirements, to many other firms as well. The result is an adverse feedback loop, as these steps force still more sales.[2]
- *Third* is a contagion effect, whereby market participants conclude from the firm's distress that other firms holding similar assets or following similar business models are likely themselves to be facing similarly serious problems.
- *Fourth* is the discontinuation of a critical function played by a failing firm in financial markets when other firms lack the expertise or capacity to provide ready substitutes.

The first two effects are largely a function of the interconnectedness of the distressed firm with other large firms, either through direct counterparty exposures or through common exposures of the firm's balance sheet with those of other firms. Typically, these first two effects will scale with a firm's size as well. These effects are directly relevant to concerns about the too-big-to-fail (TBTF) syndrome that have animated much of the reform debate in the past few years.

The traditional TBTF concern is that of moral hazard--the expectation that, when faced with the prospect of either variant of a major blow to the financial system, government authorities will provide funds or guarantees to the firm to keep it functioning. Creditors and managers of firms who anticipate such support may not price into their credit or investment decisions the full risk associated with those decisions. As a result, the firms may become more leveraged and thus still larger, an outcome that would only reinforce the belief that the government will not allow them to fail. The consequence can be both a competitive funding advantage for these large firms and more underlying risk to the financial system.

Important as it is, moral hazard is not the only worry engendered by very large, highly interconnected firms in financial markets. Assuming that a government overcomes time-consistency problems and credibly binds itself not to rescue these institutions, their growth would presumably be somewhat circumscribed. But it is possible, perhaps likely, that some combination of scale and scope economies, oligopolistic tendencies, path dependence, and chance would nonetheless produce a financial system with a number of firms whose failure could bring about the very serious negative consequences for financial markets described by the domino and fire-sale effects.

In contrast to these first two effects, the contagion effect is not necessarily a function of size at all. The run on money market mutual funds began in September 2008 after the "breaking of the buck" by the Reserve Primary Fund, less because of its size than because of what its vulnerability told investors about the balance sheets of other funds. Earlier that year, stress on the British banking system had increased significantly following the failure and subsequent nationalization of Northern Rock, a mid-sized bank heavily concentrated in residential mortgage activity. The stress arose

not from the direct effects of Northern Rock's failure, but because it focused attention on the problems in British mortgage markets.

This distinction is very important, since the contagion effect can plausibly originate in a very large number of firms, depending on circumstances in financial markets as a whole. Indeed, the failure of almost any financial firm could bring about systemic problems if markets believe that failure reveals heretofore unrecognized problems with one or more significant classes of assets held by many financial actors, especially where the assets are associated with considerable degrees of leverage, maturity transformation, or both. That is, the broader economic and financial environment interacts with the new knowledge produced by a firm's failure to determine whether a contagion effect develops.

The fourth effect, relating to an essential role in financial markets, also need not be a function of size, though it is surely related to a particular kind of interconnectedness--one that may have little to do with the assets of the firm and could instead rest on the firm's status as a node through which an important class of financial transactions flows.

Implications for Regulatory Policy

The foregoing observations inform the execution of two important administrative assignments given by Congress in last year's Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). First, section 113 of the Dodd-Frank Act gave the newly created Financial Stability Oversight Council (FSOC) authority to subject nonbank-affiliated financial firms to prudential standards and consolidated supervision if the FSOC determines that they could pose a threat to the financial stability of the United States. Second, section 165 instructs the Board of Governors of the Federal Reserve to develop special prudential standards and apply them to any bank holding company with assets of more than $50 billion, as well as to any firms designated by the FSOC.

With respect to the issue of designation, the difference in congressional approach for bank-affiliated and nonbank-affiliated firms is the starting point for analysis. In specifying that all bank holding companies with more than $50 billion in assets be subject to enhanced supervisory and prudential standards, Congress obviated the need for a determination of whether the consequences of failure of any of these institutions warrants special regulation. In contrast, with respect to the designation of nonbank institutions, Congress has required the FSOC to consider a lengthy list of factors, which collectively emphasize the importance of various attributes of size and interconnectedness. The FSOC's designation function is governed by administrative law features such as notice, opportunity for hearing, a statement of reasons for decision, and judicial review.

The combination of this legal structure and my earlier delineation of the ways in which a distressed firm can contribute to systemic risk suggests that the designation of firms under section 113 is both an important tool for safeguarding financial stability and a limited one. It is important because the recent financial crisis made clear that the failure of certain financial institutions outside the perimeter of mandatory prudential regulation could have major systemic effects. Moreover, if and as other firms outside that perimeter grow so as to pose similar risks--whether because of the migration of risky activities from the regulated sector or for other reasons--it will be important to apply prudential standards and consolidated supervision in a timely fashion.

Still, the tool of designating firms is a limited one. The structure established by Congress itself suggests that the standard for designation should be quite high. Congress could, for example, have made every financial firm with more than $50 billion in assets subject to prudential standards and consolidated supervision, but it chose not to do so. Instead, it required an administrative determination on the basis of a list of factors which, though not by its own terms exclusive, leans heavily toward characteristics associated with the first two kinds of systemic effects from failed firms.

Furthermore, the rationale for regulation provided by the potential for contagion effects is really an argument for sound regulation of the type of financial firm or instrument under consideration. If a small money market fund's travails can provoke a run on the entire industry, then all such funds should be subject to requirements that reduce the fragility of their business model. The potential for systemic problems would be essentially as great in an industry structure with many mid-sized funds as in one with a smaller number of large funds.

Another consideration is that prudential standards designed for regulation of bank-affiliated firms may not be as useful in mitigating risks posed by different forms of financial institutions. Continuing with the money market fund example, the options for reform identified by the President's Working Group on Financial Markets show that these standards may not be the optimal form of regulation.[3] Note, for example, that while money market funds engage in maturity transformation, they have essentially no leverage.

All this suggests to me that the initial list of firms designated under section 113 of the Dodd-Frank Act should not be a lengthy one. In part this is because some of the most obvious pre-crisis candidates--the large, formerly free-standing investment banks--have either become bank holding companies, been absorbed by bank holding companies, or gone out of existence. Any additional institutions so designated should probably present some combination of the first and second kinds of systemic effects discussed earlier and reflected in many of the factors enumerated in section 113. That is, the emphasis ought to be on the direct consequences of the firm's failure. The potential for systemic risk from contagion effects really reflects the potential failure of an asset class or business model more than a firm. These risks are, at least presumptively, more effectively addressed head-on.[4]

Of course, just as the existence of a contagion effect depends on the economic and financial circumstances in which a firm's failure arises, so the universe of firms whose failure would produce the first two effects will also vary. When Drexel, Burnham failed in 1990, there were consequences in financial markets to be sure, but nothing approaching a systemic problem, whereas the failure of Lehman Brothers in 2008

sparked a conflagration in what was then the very dry tinder of financial markets. At some point of sufficiently high stress, the conceptual distinctions among the first three kinds of effects may in practical terms elide, since even a smaller firm could be the proverbial straw that broke the camel's back. For purposes of designating firms under section 113, it makes little sense to hypothesize all such crisis moments, since under this reasoning virtually all firms pose systemic risk. But it may be appropriate to assume a moderate amount of stress in financial markets when considering the first and second kinds of effects that would follow a firm's failure.

One additional issue bears mention here. During the legislative debate, a question was raised as to whether identification of institutions as systemically important would itself exacerbate moral hazard. The worry was that markets would regard such identification as confirmation that the government did indeed regard a firm as too-big-to-fail. Part of the rationale for setting the statutory standard of $50 billion in assets for bank-affiliated firms was that the failure of some of these firms, while likely to cause some noticeable disruptions in financial relationships, would not be regarded as necessarily endangering the financial system. Any link between the list of firms and TBTF is thereby attenuated. There is a reasonable concern that designating a small number of nonbank-affiliated firms would increase moral hazard concern.

There is no complete answer to this concern, but the possible alternative approaches would likely be more problematic. Doing nothing would mean allowing the presence and growth in markets of large unregulated firms, creating the potential for large negative effects on the financial system should they follow the path trodden by some such firms in the years preceding the crisis. On the other hand, as already suggested, treating financial firms of all sorts as banks could be both ineffective and inefficient. The Dodd-Frank Act does provide discretion to the Federal Reserve to apply other, "similarly stringent" capital requirements where bank standards are not "appropriate."[5] While this discretion may well be needed in particular cases, broad application of that approach would in effect require the Federal Reserve to develop new capital regimes for different segments of the financial system. In declining to extend the $50 billion standard to nonbank-affiliated firms, members of Congress may have been influenced by some of these considerations. Again, if there are latent systemic risks in one or more of these segments, a more targeted, industry-wide response would be preferable. Finally, any moral hazard that might be created by the designation process should be substantially offset by the specially applicable supervisory and regulatory requirements, to which I now turn.

Implementing the Special Supervisory and Prudential Requirements

We are still the midst of developing the regulations that will set these requirements, as well as some related international initiatives, so I cannot this afternoon give you a full review of how the Federal Reserve will implement the rules required or authorized by the Dodd-Frank Act. I do, however, want to suggest a few principles that should inform the broader task of regulating and supervising the institutions covered by that statutory provision--whether through stricter capital and liquidity regulation, risk management, concentration limits, resolution plans, or the other mechanisms set forth in the Dodd-Frank Act. I hasten to add that this is not an exhaustive list, but one designed to be suggestive of the directions in which systemic regulation should be heading.

First, and fundamentally, it is important to recognize that the purpose of this special regulatory regime is macroprudential. It would be unrealistic, even dangerous, to believe that asset bubbles, excessive leverage, poor risk assessment, and the crises such phenomena produce can all be prevented. The goal of the regulatory regime should be to reduce the likely incidence of such crises and, perhaps more importantly, to limit their severity when they do occur. This argues for fostering a financial sector capable of withstanding systemic stresses and still continuing to provide reasonably well-functioning capital intermediation through lending and other activities. The aim is not to avoid all losses or any retrenchment in lending and capital markets. It is to prevent financial markets from freezing up as they did in the latter part of 2008.

A second principle is that achieving the aim of preserving reasonably effective intermediation even in a period of significant stress requires steps to ensure that market actors are, in the main, willing to deal with another by providing the liquidity necessary to support intermediation functions. During the last crisis this willingness essentially disappeared. It was restored--and then just partially--only through extensive government programs that provided liquidity and capital to broad segments of financial firms and markets.

Much of the subsequent reform impulse has been animated by a determination to avoid a repeat of this result. But while ex ante restrictions on ex post government assistance may increase market discipline and thus mitigate somewhat the amounts of risk and exposure in the system, such restrictions alone will not make financial actors willing to deal with one another when a serious dislocation nonetheless occurs. A characteristic of a financial crisis is that the bursting of asset bubbles, shortage of liquidity, and sudden fragility of leverage combine with the opaque nature of the balance sheets of financial firms to produce high--sometimes extreme--levels of uncertainty as to how to value assets and assess the soundness of counterparties. It is precisely that uncertainty that freezes markets and, historically, has induced governments of many countries and ideological persuasions to buttress the system through some combination of loans, guarantees, capital infusions, and nationalization.

If these heights of uncertainty are to be avoided, and intermediating activity is to continue even at the peak of a stress event, financial actors must have a basis for believing that their counterparties can survive. Thus, it is important to set capital requirements such that the institutions designated by Congress or the FSOC could reasonably be expected to absorb losses associated with systemic stress without extraordinary government assistance, and still be well enough capitalized to serve as sound intermediaries. Note that this is important both in order to preclude the need for government assistance and also to give assurance to those who might fund these institutions in a period of stress.

Third, systemic risk supervision and regulation must be forward-looking. The capital ratios familiar in banking regulation are at best a snapshot of the present and, if reserving for losses has lagged, not even that. Actual and potential counterparties are

less interested in a firm's capital ratio at the moment they extend liquidity than they are in the ability of the firm to return those funds in the future, as called for in their contractual arrangements. That is why, in the Supervisory Capital Assessment Program (SCAP) conducted in early 2009 and again in the Comprehensive Capital Analysis Review (CCAR) conducted early this year, the Federal Reserve focused instead on the common equity ratio that firms would maintain following losses that could be expected in an adverse scenario.

A forward-looking, macroprudential perspective also requires attention to the co-movement of firms' asset valuations and revenues in a stressed environment. This perspective reflects the fact that some losses are likely to be realized only in a systemic event. For this reason, in our recent CCAR exercise we required the six largest firms to estimate potential losses from trading and related activities using the same severe global market shock scenario that was applied in the SCAP. In fact, we actually required the firms to assume an instantaneous revaluation of their positions based on the change in market risk that occurred during the entire second half of 2008. In future supervisory exercises of this sort, we will need to find additional ways to take account of co-movement effects.

The Unfinished Agenda

Even this brief and selective sketch of some elements of a regulatory regime for systemic risk reveals important issues that have yet to be tackled in the reform agenda. Mindful of my time constraints, I will limit myself to identifying two.

The first issue arises from my suggestion that, to a considerable extent, potential contagion effects are best contained by directly addressing them, rather than by trying to indirectly address them through designating large numbers of nonbank-affiliated institutions under section 113 of the Dodd-Frank Act. This direct approach would, I believe, yield maximum financial stability benefits at the lowest cost to financial intermediation, financial firms, and financial supervisors. But these benefits obviously depend on these better targeted forms of regulation actually being developed and implemented.

In this regard, it is noteworthy that while the term "shadow banking system"[6] has taken its place in the lexicon of policymakers alongside "systemic risk" and "financial stability," comparatively little has been done to regulate the channels of capital flows in which one or both transacting parties lie outside the perimeter of prudentially supervised institutions. This despite the often considerable degree of leverage and maturity transformation associated with many of these channels. In part, the relative lack of reform directed at the shadow banking system is a result of the fact that it was substantially disrupted by the financial crisis, and that some of its more unstable parts have fortunately disappeared. Yet there are certainly significant pieces that have survived and that serve important purposes in financial markets. I have already mentioned money market funds as one example. Although many broker-dealers are parts of bank holding companies, the breadth and significance of the repo market suggest that it may be another.[7]

Just as important as dealing with systemic risks that might be posed by vestiges of the pre-crisis shadow banking system is the ability to monitor and, where necessary provide oversight for, the new conduits that are almost surely to develop in the future. In fact, it may be useful to require some systematic and standardized reporting by some classes of nonbank-affiliated firms, even without a designation under section 113.

With respect to both old and new channels, there is an important and growing academic literature on various aspects of the shadow banking system. There is now a formal exercise sponsored by the Financial Stability Board to identify policy approaches and options for ensuring that the shadow banking system does not again grow so as to pose a threat to financial stability. My hope is that these sources will serve as a catalyst for more active policy discussion and, eventually, action. In the absence of appropriate regulatory, and possibly legislative, action, the section 113 designation tool will inevitably bear more of the weight in policies crafted to contain systemic risk.

The second issue to which I would draw your attention is the absence of a deep body of analytic work on which to form judgments about the social utility of very large, complex financial institutions. This issue surfaced during the debates over financial reform in 2009 and early 2010, when some argued that the only way to counteract TBTF and its attendant risks for society was to break up these institutions.& Advocates of this approach asserted that there was little or no academic support for the proposition that the largest firms needed to be their current size in order to provide whatever efficiencies were achievable. While this is true enough, it is obviously the case that the failure to find such efficiencies does not mean they do not exist. Given the surprisingly small number of studies on this issue, one might reasonably be reluctant to draw conclusions in either direction.

While proposals to break up large, complicated financial firms did not win the day, the issue of what economies and, possibly, diseconomies of scope and scale attach to these institutions remains very relevant today. Consider, for example, that measures designed to contain systemic risk associated with these firms will create incentives and disincentives for them. Agencies will be much better positioned to make cost-benefit assessments of different regulatory approaches if they have a solid foundation of analytic work that helps them understand when and why firms do or do not need a certain size or scope to serve useful capital allocation roles. There is also need for more study of the dynamics by which stress at large, interconnected institutions can have negative effects on national and global financial systems. In fact, what may be needed is a new subdiscipline that combines the perspectives of industrial organization economics with finance. Without work of this sort, it may be difficult to fashion the optimally strong, sensible, post-crisis regulatory regime.

Conclusion

Even when the crisis was at its apex, students of history recognized that the momentum for reform of the financial system that was then so strong could fade quickly. Legislators and officials move on to other issues, as does the public. There is

some reason to believe this waning of interest and support has already occurred. The reform agenda that variously includes Basel III, administrative implementation of the Dodd-Frank Act, and other initiatives continues, to be sure. But, particularly with respect to the shadow financial system, there is much that remains to be done.

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1. The views presented here are my own and not necessarily those of other members of the Board of Governors of the Federal Reserve System or the Federal Open Market Committee. Return to text

2. A related effect is liquidity hoarding, whereby firms suspend their normal extensions of liquidity to other firms in anticipation of, and in an effort to insulate themselves from, domino or fire-sale effects. Return to text

3. President's Working Group on Financial Markets (2010), *Money Market Fund Reform Options* (436 KB PDF), October. Return to text

4. I do not address further here the rather special case of a firm whose failure would bring about the fourth kind of effect--the removal of a critical function in the financial system--but that doesn't otherwise have the size and asset composition to elicit the first and second kinds of systemic effects. To a considerable extent, this issue is addressed in Title VIII of the Dodd-Frank Act, which calls for the separate designation and regulation of "systemically important financial market utilities." Return to text

5. This discretion is granted only for capital standards, not for the other prudential standards required by section 165. Return to text

6. For a survey of the entire shadow banking system, see Zoltan Pozsar, Tobias Adrian, Adam Ashcraft, and Hayley Boesky (July 2010): "Shadow Banking (878 KB PDF)," *Federal Reserve Bank of New York Staff Reports*, no. 458. Return to text

7. See Daniel K. Tarullo (2010), "Comments on 'Regulating the Shadow Banking System,'" remarks delivered at the Brookings Panel on Economic Activity, Washington, September. Return to text

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5. Articles on British banks facing tougher standards than those in U.S.

a. UK moves bank rules closer to US
By Francesco Guerrera in New York and Sharlene Goff in London
Financial Times
Published: April 11 2011 18:33 | Last updated: April 11 2011 18:33

Global banking regulation took a step towards convergence on Monday as a UK commission proposed measures that will bring the country's financial rules closer to the US, reducing fears that British lenders will flee London for New York.

The Independent Banking Commission, led by Sir John Vickers, stopped short of forcing banks to split their securities businesses from their retail and commercial lending operations – a radical plan that had been bitterly opposed by the industry.

Bankers reacted with relief at the commission's proposal that UK lenders instead place their retail operations – deposits, small business lending and payment systems – into a separate subsidiary and hold more capital against it than currently required.

The moves are aimed at ensuring that retail units can keep functioning even if the investment and commercial banking businesses suffer large losses, as in the recent financial crisis.

The proposed changes – which have to be finalised by September – are similar to regulations in the US, where banks are limited in the amount of deposits they can use for investment banking and commercial banking activities.

"The proposals echo the structure that has been in place in the US for the last decade, which require commercial banking to be separated from other financial activities," wrote Simon Gleeson, a partner at Clifford Chance.

However, the UK plan goes further than the US, where banks do not face the same capital requirements for their retail units. The Vickers' recommendations would also require British lenders to hold 10 per cent of core tier one capital in their retail business, more than the 7 per cent envisaged by Basel III international agreement.

Nevertheless, bankers and analysts said the commission's recommendations would not trigger the exodus of lenders and bankers from the City of London that had been threatened by some executives in the run-up to the report.

"Decisions by major banking institutions about where to locate their headquarters are more likely to be influenced by longer-term assessments of market growth and business strategy than by these recommendations," wrote Richard Reid, head of research at the International Centre for Financial Regulation in a note to clients.

National regulators have striven to achieve greater co-ordination in how rules are written and implemented in order to crack down on "regulatory arbitrage" by large banks.

Some executives such as JPMorgan Chase's Jamie Dimon have called for more homogeneous rules, warning that an uneven playing field would put banks in some country at a disadvantage to international rivals.

b. British Bank Panel Suggests Ways to Limit Consumer Risk
By JULIA WERDIGIER
791 words
12 April 2011
The New York Times

LONDON - British banks should hold more capital and better shield individual customers from losses in other parts of their business, a government-backed commission said on Monday.

The proposals stopped short of any significant new regulations, like requiring a full split of retail and investment banking, which some banks had feared.

Instead, the commission said retail units, which take consumer deposits, should be isolated for protection, or ring-fenced, to allow them to survive even if other parts of the banks need to be wound down.

Shares in British banks were mixed in London on Monday, with Barclays and Royal Bank of Scotland rising and HSBC falling.

"The report has been extremely generous to the banks," said Roger Nightingale, a strategic adviser to hedge funds and institutional investors in London.

The proposals, by the Independent Commission on Banking, go further than recent changes in the United States in trying to separate more clearly the traditional deposit-taking services from the riskier but more lucrative trading operations.

The commission also said larger banks, like Barclays, should hold at least 10 percent of equity related to risk-weighted assets, more than the 7 percent detailed in the so-called Basel III agreement to overhaul international bank regulation.

But the commission also said that because investment banks operate globally, British banks should not be subject to different capital rules than those agreed to internationally.

The proposed ring-fencing of the retail business means that banks with both retail and investment banking units, including Barclays and Royal Bank of Scotland, would have to finance the two businesses separately and not move capital from one area to the other.

The proposed changes would increase a bank's financing costs, the commission said, but not as much as a complete split of retail and investment banking. And any costs would be more than offset by the benefit of "materially reducing the probability and impact of financial crises," the report said.

Simon Gleeson, a partner at the law firm Clifford Chance, in London, said the proposed changes could prompt banks to take on more rather than less risk, or to raise prices for retail customers as the cost of doing business increases. "All of this would make the operating of retail banks more expensive," he said.

The proposals are part of an interim report and are not definitive. But they were seen as Britain's most important response to the banking crisis, which has left two of the country's largest banks in government hands. Before the release of the report, Barclays and HSBC had threatened to move their headquarters abroad should new rules be too punishing, which they argued would leave them at a disadvantage to rivals elsewhere.

John Vickers, who heads the commission, rejected claims that the commission bowed to bank pressures. "These are absolutely far-reaching reforms," Mr. Vickers said at a news conference in London. "They could be absolutely transformative."

The commission, which includes former banking executives, was set up by the government in June to suggest ways to improve stability and competition in Britain's banking industry after the financial crisis. The Treasury is expected to receive a final report in September.

George Osborne, the chancellor of the Exchequer, welcomed the interim report as a "very, very good piece of work."

Under the proposals, any retail banking operations would have to be run as a subsidiary of the larger banking group. The subsidiary would have to stick to its own capital ratios, but any capital above that could be moved from the retail banking business to other activities in the wider group. The banking group would also be able to continue selling financial products across its units, for example offering investment banking advice to retail banking clients.

"It would help shield U.K. retail activities from risks arising elsewhere within the bank or wider system," the report said. "It could curtail taxpayer exposure and thereby sharpen commercial disciplines on risk taking."

The commission said its recommendations sought a middle ground between the radical step of separating retail and investment banking and simply relying on higher capital requirements to increase the stability of banks.

In the event of the collapse of a bank, the commission suggests that claims of depositors should be ranked higher than those of unsecured creditors. "It's amazing how so many senior debt holders came out whole" from the banking crisis, Mr. Vickers said.

The commission also recommended making it easier and less expensive for customers to switch between British retail banks as a way to increase competition.

c. Global Finance: Big Banks in U.K. Dodge Breakup
By David Enrich
429 words
12 April 2011
The Wall Street Journal

LONDON -- A government-appointed panel said it is likely to recommend structural changes to the U.K. banking sector, but stopped short of suggesting that any of the country's biggest banks be broken up.

The Independent Commission on Banking, appointed last year to study ways to make the banking industry safer and more competitive, on Monday issued an anxiously awaited interim report on the options it is considering as it conducts a review of the industry's structure. The five-member panel will release its final report in September. Its recommendations to the U.K. Treasury are nonbinding.

The centerpiece of the commission's 208-page preliminary report Monday was a recommendation that institutions housing both retail- and investment-banking operations be required to maintain separate pools of capital for each of those business lines.

The goal is to insulate retail-banking operations from potential losses that arise in other areas that generally are perceived as riskier. The commission also argues that such a change would make it simpler to unwind ailing banks in a crisis, alleviating the phenomenon of banks requiring taxpayer bailouts because they are considered too big to fail.

Banks had lobbied against such a so-called ring-fencing option, arguing that it would be costly and wouldn't make the industry safer. Still, the outcome was favorable compared with what some had feared: that the commission would recommend that "universal" banks like Barclays PLC be required to split into separate retail- and investment-banking companies.

The banks appear to have dodged that bullet, although the commission's chairman cautioned that such a recommendation still could make its way into the panel's final report. "Nothing along these lines is completely off the table," the chairman, John Vickers, said at a London news conference Monday.

U.K. Treasury chief George Osborne isn't required to implement the proposals. He praised the panel's "excellent analysis" and said he looks forward to its final recommendations.

Investors seemed mildly relieved that the panel didn't recommend more-draconian measures. In London trading, shares of Barclays rose 2.8%, Royal Bank of Scotland Group PLC gained 2.3%, and Lloyds Banking Group PLC edged up 0.3%. HSBC Holdings PLC fell 0.7%.

If implemented, the commission's recommendations could force U.K. banks to hold more capital, because their retail- and investment-banking arms would each need their own capital bases.